O. PRIVATE FOUNDATIONS IN THE MID-1990s WITH AN EMPHASIS ON IRC 4941 AND IRC 4945

by
Virginia Richardson and Bill Brockner

1. Introduction

The Revenue Act of 1950 contained provisions intended to correct some perceived abuses by certain types of charities. Most charities were excluded from the reach of these provisions, except for that class of organizations we now characterize as private foundations. However, these provisions eventually were viewed as inadequate to accomplish their intended purposes. Additionally, the sanction of losing tax-exempt status seemed too extreme in comparison to the prohibited acts committed, and sometimes punished the victim rather than the perpetrator, resulting in a reluctance to revoke tax exemption despite clear statutory violations. As a result, the Chapter 42 provisions of the Internal Revenue Code, enacted in the Tax Reform Act of 1969, added the excise tax sanctions to the already existing sanction of loss of tax exempt status. These excise taxes are imposed on certain individual participants in the abuses in some instances, and on the foundations themselves in other instances. Also, the newer provisions provided more objective descriptions of prohibited acts than those previously contained in earlier provisions. (IRC 503 and 504).

The history of the Chapter 42 provisions, as well as the analysis of these provisions is particularly cogent at present because of the possibility that legislation may be enacted providing for intermediate or interim sanctions for IRC 501(c)(3) public charities and IRC 501(c)(4) organizations. On November 22, 1993, Representative Fortney "Pete" Stark, (D-Calif.) introduced the "Exempt Organization Reform Act of 1993," H.R. 3697. The Act would impose interim sanctions in the form of excise taxes on private inurement and self-dealing transactions of the above-referenced exempt organizations. The Department of the Treasury has also come out in favor of a legislative proposal that would tax "insiders" on excess benefits received from public charities and the Subcommittee on Oversight of the House Ways and Means Committee has held public hearings on the subject. Whether laws will be enacted to address a perceived need to more adequately regulate public charities is unclear at this writing. However, the current debate on proposed interim sanctions is similar to the debate that occurred over twenty-five years ago in the private foundation area prior to the Tax Reform Act of 1969. Also, if interim sanctions are adopted, it is possible that the form and interpretation of these new sanctions may draw upon Service experience with Chapter 42.

This article will provide a general review of IRC 4941 and IRC 4945, with an emphasis on some recent cases and developments. For those persons who are interested in concentrating on updates in the area, special focus issues are highlighted in the subject directory. Self-dealing discussions will involve the pay scale of government officials who are disqualified persons, self-dealing in compensation packages, stock redemptions, loans, earmarking, "personal services", and insurance indemnifications. Taxable expenditure issues include discussions about generic affidavits, emergency funds of company foundations, and incubators.

The article will also highlight some interesting and recent developments and cases under IRC 4942 and 4943, along with a discussion of revocation and IRC termination remedies in abuse cases.

The general counsel memoranda and private letter rulings are cited for illustrative purposes only, and cannot be used or cited as precedent.

2. IRC 4941. General Explanation

IRC 4941 imposes a series of excise taxes on any direct or indirect act of self-dealing between a private foundation and a disqualified person. The first tier of excise taxes is imposed on the disqualified person, other than a foundation manager, who participates in an act of self-dealing. As for foundation managers, an added element of knowledge is required before excise taxes may be imposed on them. Thus, a foundation manager who participates in an act knowing the act to be self-dealing is subject to the tax, unless his or her participation is not willful and is due to reasonable cause. IRC 4941(a).

IRC 4941 is discussed in the following CPE texts: 1985 (The Nature of Self-Dealing), 1989 (Part II. Technical and Miscellaneous Revenue Act of 1988), and 1990 (Recent Developments).

A. Disqualified Persons

(1) General

In order to have an act of self-dealing, there must be: 1) a private foundation[1] and 2) a disqualified person. Disqualified persons are defined in IRC 4946(a)(1). IRC 4946(a)(1) provides, in pertinent part, that the term "disqualified person" means a person who is --

(A) a substantial contributor to the foundation,
(B) a foundation manager,
(C) an owner of more than 20 percent of --
  (i) the total combined voting power of a corporation,
  (ii) the profits interest of a partnership, or
  (iii) the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation,
(D) a member of the family of any individual described in subparagraphs (A), (B) or (C),
(E) a corporation, partnership, trust or estate, if more than 35 percent owned, directly or indirectly, or held by persons described in (A) through (D), above; or
(F) a government official.

(2) Categories of Disqualified Persons

a. Substantial Contributor

A substantial contributor is defined in IRC 507(d)(2)(A) as a person who: 1) contributes or bequeaths more than $5,000 to a private foundation (adding all contributions and bequests in his or her lifetime) and 2) the aggregate amount of the person's gifts and bequests amounts to more than two percent of the total contributions and bequests for all years received by the foundation before the close of the foundation's tax year. In the case of a trust, a substantial contributor is the creator of the trust.

The two percent test is applied on the last day of the foundation's taxable year. If the person's aggregate contributions and bequests are more than $5,000

[1] Certain non-exempt charitable trusts are also treated as private foundations for purposes of IRC 4941. IRC 4947. Conversely, if a trust is recognized as exempt under IRC 501(c)(4), it is not treated as a private foundation. Thus, IRC 501(c)(4) recognition should not be granted to a trust that is attempting to avoid Chapter 42 if it is otherwise described in IRC 501(c)(3). See also G.C.M. 37485 (March 30, 1978).

and exceed two percent of the foundation's total contributions at the end of the foundation's tax year, the person is deemed a substantial contributor as of the date of the qualifying distribution. Reg. 1.507-6(b)(1). Each contribution or bequest is valued on the date it is received.

Once a person becomes a substantial contributor, he or she retains this status even if he or she would not meet the test at some later date. Substantial contributor status would only terminate if he or she meets the requirements of IRC 507(d)(2)(C). They are:

1) During the ten year period ending on the close of the taxable year, such person and all "related persons" have not made any contributions to the foundation;

2) At no time during the ten-year period was the person or a "related person" a foundation manager of the foundation; and

3) The aggregate contributions made by the person and all "related persons" are determined by the Secretary to be insignificant when compared to the aggregate contributions of one other person to the foundation. (H.R. Rep. No. 432, Part II, 98th Congress, 2d Sess. 1484 (1984) states that the Committee intended that contributions generally are to be considered insignificant if they are less than 1 percent of the contributions of another person.)

Rev. Rul. 73-455, 1973-2 C.B. 187, holds that an organization that is a nonexempt charitable trust described in IRC 4947(a)(1) that has made contributions to a private foundation in excess of the limitation in IRC 507(d)(2) is not a 'substantial contributor' within the meaning of that section for purposes of the tax on self-dealing under IRC 4941. Reg. 1.507-6(a)(2) provides, for purposes of IRC 4941, that a substantial contributor does not include an IRC 501(c)(3) organization (other than one described in IRC 509(a)(4)). The exception provided in Reg. 1.507-6(a)(2) for IRC 501(c)(3) organizations also applies to nonexempt charitable trusts described in IRC 4947(a)(1).

b. <u>Foundation Manager</u>

A foundation manager is an officer, director, or trustee of a foundation or any person having authority or responsibility for any of the acts prohibited under the self-dealing provisions. IRC 4946(b). A person is considered to be an officer of a foundation if he or she is specifically designated in the constitutive documents of the foundation or he or she regularly makes administrative or policy decisions for the foundation. Reg. 53.4946-1(f)(2). Independent contractors such as attorneys, accountants, and investment managers and advisors acting in such capacity are not officers. Id.

Rev. Rul. 74-287, 1974-1 C.B. 327, holds that certain employees of a bank designated as the trustee of a private foundation were foundation managers within the meaning of IRC 4946(b)(1). The employees had been delegated fiduciary responsibility for the day-to-day administration and distribution of the trust funds. As a result, the employees were free, on a day-to-day basis, to administer the trust and distribute the funds according to their best judgment. Therefore, the employees had powers or responsibilities similar to those of trustees of the foundation. The ruling holds that the employees were disqualified persons as defined in IRC 4946(a)(1)(B) even though they were ultimately responsible to the bank directors and officers for their actions with respect to the trust.

Rev. Rul. 78-77, 1978-1 C.B. 378, presents the following set of facts. A private foundation purchased property from a testamentary trust. A banking institution was the trustee of both the private foundation and the trust. The ruling holds that the purchase was not an act of self-dealing under IRC 4941(d)(1)(A) merely because the banking institution was the trustee of both the private foundation and the testamentary trust because the trust was not a disqualified person within the meaning of IRC 4946(a) with respect to the foundation.

c. 20 Percent Owner

The owner of more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interests of a trust or unincorporated enterprise, which is a substantial contributor is a disqualified person. Combined voting power includes voting power represented by holdings of voting stock, actual or constructive, but does not include the voting power held as a director or trustee. Reg. 53.4946-1(a)(5). Combined voting power also does not include voting power which is obtainable but not yet obtained. The mere right to convert securities or nonvoting stock into voting stock or to exercise warrants or options to obtain voting stock is not sufficient to count these rights or options in the calculation of voting power. Reg. 53.4946-1(a)(6).

The profits interest of a partnership is equal to the partner's distributive share of income of the partnership. Reg. 53.4946-1(a)(2). The beneficial interests of a trust are apportioned among beneficiaries in accordance with their actuarial interests. Reg. 53.4946-1(a)(4). The beneficial interest in an unincorporated enterprise, other than a trust or estate, includes any right to receive a portion of distributions from profits of the enterprise. If the portion of distributions is not fixed by an agreement among the participants, the beneficial interest in an unincorporated enterprise consists of any right to receive a portion of assets upon liquidation of the enterprise, except as a creditor or employee. See Reg. 53.4946-1(a)(3).

Rev. Rul. 81-76, 1981-1 C.B. 516, provides that an employee stock ownership trust was not a disqualified person with respect to a private foundation. The trust held 30 percent of the stock of a corporation that was a substantial contributor to the foundation. The participating employees directed the manner in which the trust voted shares. Therefore, to the extent the trust had any voting power, it merely held the voting power as trustee and not as owner of the stock. Thus, the trust was not a disqualified person within the meaning of IRC 4946(a)(1)(C).

d. Member of Family

The fourth category of disqualified person is a member of the family of any person described in IRC 4946(a)(1)(A) through (C) above. IRC 4946(a)(1)(D). IRC 4946(d) defines a family member as an individual's spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren.

e. 35 Percent Owner

The fifth category of disqualified person is a corporation, partnership, trust or estate, if more than 35 percent owned, directly or indirectly, or held by persons described in IRC 4946(a)(1)(A) through (D). IRC 4946(a)(1)(E). G.C.M. 39445 (July 11, 1985) indicates that while an estate may be a disqualified person, it will be characterized as such only if it qualifies under the foregoing tests. An estate will not be a disqualified person merely because the decedent was a disqualified person. See also G.C.M. 37621 (July 28, 1978).

f. Government Official

A government official is considered to be a disqualified person. IRC

4946(a)(1)(F). A government official is defined in IRC 4946(c) as any person who, at the time of the self-dealing act, holds any of the following offices or positions:

1) an elective public office in the executive or legislative branch of the U.S. government;

2) a Presidentially appointed office in the executive or judicial branch of the U.S. government;

3) a position in any branch of the U.S. government

   (A) which is listed in Schedule C of Rule VI the Civil Service Rules, or

   (B) the compensation for which is equal to or greater than the lowest rate of compensation prescribed for GS-16 of the General Schedule under section 5332 of title 5, United States Code;

4) a position under the House of Representatives or Senate at a salary of at least $15,000 per year;

5) an elective or appointive public office in state or local government at an annual salary of at least $20,000 per year; or

6) a position as personal or executive secretary of any of the above.

As an example, Rev. Rul. 77-473, 1977-2 C.B. 421, addressed whether a member of a state legislature was a disqualified person. The elected member of the state legislature received a salary of less than $15,000 per year and an expense allowance of a fixed amount. However, the salary and expenses together amounted to more than $15,000 per year. The ruling held that since the individual's gross compensation from public office is greater than $15,000 per year, the individual was a disqualified person within the meaning of IRC 4946(a) by virtue of being a government official described in IRC 4946(c)(5).[2]

[2] The Tax Reform Act of 1986 increased the threshold compensation level to $20,000. For compensation paid before 1986, the limit was $15,000.

i. Definition of a Public Official Relating to the GS Pay Scale

The definition of a government official under IRC 4946(c)(3)(B) is essentially obsolete because there is no longer a GS-16 category of compensation. For purposes of this section, the Service is considering issuing guidance. Following section 102(a) of Pub. L. 101-509, the present Service view is that for a government official described in IRC 4946(a)(1)(F), the compensation is equal to or greater than 120 percent of the basic pay for GS-15. This would be the equivalent of a GS-15, Step 7 pay which is currently $83,310. Questions relating to the obsolete language should be submitted to the National Office.

(3) Important Exceptions to Disqualified Person Status

Organizations described in IRC 501(c)(3) are not considered to be disqualified persons for purposes of the self-dealing rules, unless they are organized and operated exclusively for testing for public safety. Reg. 53.4946-1(a)(8). Also, organizations wholly owned by IRC 509(a)(1), (2) or (3) organizations are not considered to be disqualified persons. Reg. 53.4946-1(a)(6). Whether a person first defined as a disqualified person always remains a disqualified person, aside from the substantial contributor category, is a matter of facts and circumstances. See Rev. Rul. 76-448, 1976-2 C.B. 368. The member of the family classification does not include siblings.

(4) Disqualified Persons Who Become Disqualified Persons Only AFTER Certain Transactions

Regarding disqualified persons, an act of self-dealing does not include a transaction whereby the disqualified person status arises only as a result of the transaction. Reg. 53.4941(d)-1(a). As an example, the regulations indicate that a bargain sale of property to a private foundation is not an act of self-dealing if the seller becomes a disqualified person only as a result of the seller becoming a substantial contributor as a result of the bargain element of the sale. Id.

B. Direct Acts of Self-Dealing

Acts of self-dealing between a disqualified person and a private foundation consist of the following:

1) the sale or exchange or lease of property;

2) the lending of money or other extension of credit;

3) furnishing of goods, services, or facilities;

4) payment of compensation or reimbursement of expenses by the foundation to a disqualified person;

5) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and

6) agreement by the private foundation to make any payment to a government official, other than an agreement to employ the official after termination of his government service if he is terminating his service within a 90-day period. IRC 4941(d)(1)(A)-(F).

More than one Chapter 42 tax can be assessed on the same act. For example, an act of self-dealing could also have implications under IRC 4942, qualifying distributions, and IRC 4943, excess business holdings, as well as being a jeopardizing investment under IRC 4944 and a taxable expenditure under IRC 4945. See Kermit Fischer Foundation v. Commissioner, T.C. Memo 1990-300 (June 18, 1990).

(1) Sales, Exchanges, and Leases

a. General

IRC 4941(d)(1)(A) provides that the term self-dealing means any direct or indirect sale of property between a private foundation and a disqualified person.

b. Encumbered Property

IRC 4941(d)(2)(A) provides that the transfer of real or personal property by a disqualified person to a private foundation is treated as a sale or exchange if the property is subject to a mortgage or similar lien which the private foundation assumes or if such property is subject to a mortgage or lien which a disqualified person placed on the property within the ten-year period ending on the date of the transfer. Similar liens include deeds of trust and vendors' liens, but do not include any other lien which is insignificant in relation to the fair market value of the property transferred. Reg. 53.4941(d)-2(a)(2).

c. Excess Business Holdings Savings Provision

Under section 101(l)(2)(B) of the Tax Reform Act of 1969, the sale, exchange, or other disposition of property which is owned by a private foundation on May 26, 1969, to a disqualified person shall not be an act of self-dealing if the foundation is required to dispose of the property in order not to be liable for tax under IRC 4943, and if the disposition satisfies the requirements of Reg. 4941(d)-4(b)(2) (generally, fair market value and no violation of previous law on prohibited transactions). Reg. 53.4941(d)-4(b)(1).

d. Examples

i. Sale or Exchange Scenarios

Rev. Rul. 76-18, 1976-1 C.B. 355, provides that the sale of a private foundation's art objects to a disqualified person at a public auction constitutes an act of self-dealing under IRC 4941(d)(1)(A). The sales were conducted by an auction gallery to which the items were consigned for sale. The ruling indicated that if the disqualified person were the highest bidder with respect to any items belonging to the private foundation's collection, the transaction would be a direct sale between the private foundation and the disqualified person, not excepted by Reg. 53.4941(d)-3 or 4.

A situation which did not result in self-dealing is found in Rev. Rul. 76-448, 1976-2 C.B. 368, which involved an exchange of securities between a private foundation and a corporation. The corporation was previously a disqualified person because the former foundation manager of the foundation owned more than 35 percent of the corporation's total combined voting power. However, the former foundation manager resigned from the foundation 5 years prior to the exchange, and did not participate in planning the exchange offer during the period of disqualification. The corporation's status as a disqualified person was attributable only to the ownership of more than 35 percent of its voting power by another disqualified person, the foundation manager. Therefore, the resignation and separation from the foundation of the foundation manager terminated the status of the corporation as a disqualified person with respect to the foundation. The ruling held that the exchange of securities between the private foundation and the corporation did not result in an act of self-dealing under IRC 4941(d)(1)(A). See

G.C.M. 36668 (March 29, 1976).

ii. Encumbered Property Scenarios

Rev. Rul. 77-379, 1977-2 C.B. 387, provides that a private foundation's transfer of stock in repayment of an interest free loan made by a disqualified person was tantamount to a sale or exchange of property between the private foundation and the disqualified person. Therefore, the transfer was an act of self dealing under IRC 4941(d)(1)(A). The loan was not an act of self-dealing because it was interest-free and because the proceeds were used exclusively for purposes specified in IRC 501(c)(3). Although the ostensible purpose of the transfer was to repay the loan, the transfer of shares in satisfaction of the debt still presents the same potential for abuse that IRC 4941 was enacted to eliminate. This stock transfer, when viewed together with the making of the loan, constituted a sale or exchange of property between a private foundation and a disqualified person within the meaning of IRC 4941(d)(1)(A).

The following two revenue rulings involve liens under IRC 4941(d)(2)(A). Rev. Rul. 78-395, 1978-2 C.B. 270, discusses a situation where a disqualified person's transfer to a private foundation of real property that was subject to a lien was an act of self-dealing under IRC 4941(d)(1)(A). The disqualified person placed the lien on the property within the 10-year period ending on the transfer date. However, the lien was created as part of a multiphase financing plan begun more than ten years earlier. Specifically, the original lien created by the deed of trust executed in conjunction with the purchase of the undeveloped real property was placed upon the property prior to the 10-year period ending on the date of transfer, December 26, 1974. However, the lien created by the deed of trust executed in conjunction with the permanent loan was placed upon the land on December 5, 1967, a date within the 10-year period. The ruling relied on IRC 4941(d)(2)(A) and Reg. 53.4941(d)-2(a)(2) in concluding that the transfer was a sale or exchange under IRC 4941(d)(1)(A). For purposes of IRC 4941(d)(2)(A), it does not matter that the taxpayer placed the second lien on the property as part of a multiphased financing program begun more than ten years before the date of transfer.

Rev. Rul. 80-132, 1980-1 C.B. 255, considered a donation of a life insurance policy, subject to a policy loan, to a private foundation by a disqualified person. The ruling reviewed the general characteristics of a life insurance policy loan. See J. Simpson Dean, 35 T.C. 1083 (1961), nonacq. 1973-2 C.B. 4 (nonacquiescence on another issue). Although the insurer will not demand repayment of the loan or payment of interest as it accrues, the loan still constitutes a 'mortgage or other lien' within the meaning of Reg. 53.4941(d)-2(a)(2). The transfer of the policy in the instant case relieves the donor of the obligation to either repay the loan, pay interest on the loan as it accrues, or suffer continued diminution in the value of the policy. Thus, the effect of the transfer is essentially the same as the transfer of property subject to a mortgage or similar lien. In addition, the amount of the loan is not insignificant in relation to the value of the policy. Therefore, the donation of the policy is an act of self-dealing within the meaning of IRC 4941(d)(1)(A). This may also involve an IRC 4944 act. Rev. Rul. 80-133, 1980-1 C.B. 258.

In Harold Gershman Family Foundation v. Commissioner, 83 T.C. 217 (1984), the court held that the transfer of a wrap-around mortgage note to a private foundation by a disqualified person constitutes an act of self-dealing. By the transfer, the disqualified person had shifted the risks to the private foundation. In that way, the disqualified person had received a benefit prohibited by the self-dealing rules.

In Adams v. Commissioner, 70 T.C. 446 (1978), a corporation owned by a disqualified person with respect to a private foundation transferred two encumbered properties to the wholly owned subsidiary of the foundation. Along with ruling that the sale, itself, constituted an act of self-dealing, the court found another act of self-dealing arising out of the encumbrances. The wholly-owned subsidiary paid full price for the properties even though they were subject to encumbrances. Either the current mortgagee or the corporation selling the properties were responsible for satisfying the liabilities on the properties. The corporation failed to immediately satisfy the liabilities upon receipt of the funds from the private foundation's subsidiary. The court held that the transaction gave rise to an implied loan from the foundation to the corporation in the amount of the outstanding mortgage liabilities.

A correction of an act of self-dealing can result in another act of self-dealing. In Rev. Rul. 81-40, 1981-1 C.B. 508, an act of self-dealing described in IRC 4941(d)(1)(B) had already occurred. This act was a loan between a disqualified person and a private foundation. The disqualified person then attempted to correct the loan by transferring real estate to the private foundation. The fair market value of the real estate equaled the amount of a loan. The ruling held that the transfer of real estate was a second act of self-dealing. For an example of guidance on appropriate correction, see PLR 91-37-006 (September 23, 1991).

iii. Excess Business Holdings Divestiture Scenarios

In certain limited circumstances involving the disposition of excess business holdings under IRC 4943, self-dealing acts under IRC 4941 do not arise. Rev. Rul. 86-53, 1986-1 C.B. 204, holds that the sale to a disqualified person of stock owned by a private foundation continuously since May 26, 1969, but not constituting an interest in a business enterprise as of such date, is excepted under Reg. 53.4941(d)-4(b)(1) from the prohibition against self-dealing under IRC 4941, if the disposition is made in order to avoid the presence of excess business holdings under IRC 4943. See also Rev. Rul. 75-25, 1975-1 C.B. 359.

(2) The Lending of Money

a. General

IRC 4941(d)(1)(B) provides that the lending of money or other extension of credit between a private foundation and a disqualified person constitutes self-dealing, regardless of whether the foundation is the lender or borrower. An act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note. Reg. 53.4941(d)-2(c)(1). See PLR 85-21-122 (February 28, 1985) and G.C.M. 37731 (February 15, 1978). Thus, an act of self-dealing can occur in an indirect as well as in a direct transaction.

b. Loans Without Interest

IRC 4941(d)(2)(B) provides an exception to the prohibition on loans or other extensions of credit. That is, the lending of money or other extension of credit by a disqualified person to a private foundation is not an act of self-dealing if the extension of credit is without interest, and if the proceeds are used exclusively for IRC 501(c)(3) purposes. But see Rev. Rul. 77-379, supra, where the transfer of stock by a private foundation to repay an interest free loan characterized the transaction as a prohibited sale. Reg. 53.4941(d)-2(c)(2) also provides for the same exception stated in IRC 4941(d)(2)(B), but does not contain the express condition regarding the use of proceeds for IRC 501(c)(3) purposes that the Code contains.

c. Future Gifts

A second exception to IRC 4941(d)(1)(B) is certain future gifts. Specifically, the making of a promise, pledge, or similar arrangement to a private foundation by a disqualified persons, whether evidenced by an oral agreement, a promissory note, or other instrument of indebtedness, to the extent motivated by charitable intent and unsupported by consideration, is not an extension of credit before the date of maturity. Reg. 53.4941(d)-2(c)(3).

d. General Banking Services

A third exception to IRC 4941(d)(1)(B) is general banking services, consisting of savings account, checking account, and safe-deposit services. The performance of these general banking services is an exception to the general rule prohibiting the lending of money between a private foundation and a disqualified person under IRC 4941(d)(1)(B), and is within the scope of the personal services which do not constitute self-dealing transactions under IRC 4941(d)(2)(E). Reg. 53.4941(d)-2(c)(4). See discussion of personal services exception, infra.

With respect to the general banking services exception, self-dealing violations may arise even if the service being provided typically falls within the three banking services listed in the regulations. In Rev. Rul. 73-595, 1973-2 C.B. 384, a private foundation deposited funds into a savings account maintained with a disqualified banking institution. The funds were deposited on the tenth day of a calendar quarter. The funds were then withdrawn before the end of the next quarter. As a result, the foundation lost interest on the funds for the entire period of deposit. Under the facts, the foundation did not have the right to withdrawal without subjecting itself to a loss of interest on its money for the time during which the money was on deposit. Therefore, the transaction was not within the scope of the general banking services permitted by the regulations. The ruling held that the deposit, under the circumstances, constituted an act of self-dealing under IRC 4941(d)(1)(B).

e. Transactions with Publications

Reg. 53.4941(d)-3(b)(2) describes a very specific commercial transaction that would be excepted from the IRC 4941(d)(1)(B) prohibition. The sale of a book or magazine by a private foundation to disqualified persons would generally not be an act of self-dealing, provided the publications are related to the foundation's charitable purposes and are offered to the general public at the same price. Further, if the terms of the sale require, for example, payment within 60 days from the date of delivery of the publication, and the terms are consistent with normal commercial practices, and payment is made within the 60-day period, the transaction will not be treated as a loan or other extension of credit under Reg. 53.4941(d)-2(c)(1).

f. Loans to Disqualified Persons

i. General

A loan from a disqualified person to a private foundation generally constitutes self-dealing, unless the loan is without interest. Likewise, a loan from a private foundation to a disqualified person is prohibited, unless it meets an exception. These exceptions are: 1) pre-1980 transitional rules and Reg. 53.4941(d)-1(b)(3) transactions, 2) future gifts, 3) general banking exceptions, and 4) the example in the regulations involving the deferred payment in the sale of publications. There do not appear to be any other specific exceptions to the prohibition on loans or other extensions of credit from a private foundation to a disqualified person. The following discusses two PLRs that provide illustrations of the IRC 4941(d)(1)(B) prohibition on loans or other extensions of credit to disqualified persons in compensation package and stock redemption scenarios.

ii. Compensation Package

PLR 93-43-033 (August 2, 1993) describes a compensation package provided to a foundation manager. The package includes an annual salary plus fringe benefits and a below-market rate mortgage loan issued by the private foundation. The note provides for 6 percent interest on the unpaid principal balance and repayment of principal and interest over 360 months at a set monthly rate. The PLR indicates that the loan does not constitute an act of self-dealing because the foundation manager's status as a disqualified person arose as a result of the transaction and the compensation was not unreasonable. The body of the PLR cited the personal services exception of IRC 4941(d)(2)(E). (See discussion of IRC 4941(d)(2)(E), infra). Also cited was the exception to self-dealing under Reg. 53.4941(d)-1(a) where the disqualified person status arises only as a result of the transaction. The PLR's rationale stated that the foundation manager's status as a disqualified person arose only as a result of the transaction, and that his compensation is not unreasonable.

PLR 94-17-018 (May 9, 1994) was issued to the taxpayer described in PLR 93-43-033. It announced that the Service is reconsidering the letter.

iii. Redemption of Stock

Another recent PLR involving an extension of credit to a disqualified person is PLR 93-47-035 (August 31, 1993). The ruling involves a trust described in IRC 4947(a)(2) that is subject to IRC 4941. A beneficiary of the trust owns over 80 percent of the shares of a corporation. The beneficiary proposed to donate a certain percentage of these shares to the trust. The corporation is a disqualified person with respect to the trust. After the donation of the shares to the trust, the corporation will make a uniform offer of redemption to all shareholders of record, including the trust. The redemption price would be the fair market price of the shares as determined by an independent appraiser.

The proposed transaction provided for an installment payment arrangement over a ten year term for the redemption of shares. The corporation would pay part of the purchase price in cash at the time of the redemption. The balance would be paid quarterly thereafter for the remaining ten year term. The trust would retain redemption notes evidencing the corporation's obligation to pay the balance of the redemption price. The ruling cited IRC 4941(d)(2)(F) which provides that any transaction between a private foundation and a corporation which is a disqualified person (as defined in IRC 4946(a)) pursuant to any liquidation, merger, redemption, recapitalization or other corporate adjustment, organization or reorganization, shall not be an act of self-dealing if all the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value. See also Reg. 53.4941(d)-3(d)(1). (In some situations, IRC 4941(d)(2)(F) may apply to partnership redemptions, etc. See PLR 92-37-032 (June 16, 1992)).

Thus, the PLR relies on IRC 4941(d)(2)(F) in concluding that the installment sale aspect is part of the redemption transaction and is not an act of self-dealing. For the reasons discussed below, this PLR is being revoked. It is interesting to note that an installment sale may be an act of self-dealing either as an extension of credit or as a sale of property. First, treating the trust's retention of redemption notes as extensions of credit from a private foundation to a disqualified person, the following issue arises. This issue is whether the exception under IRC 4941(d)(2)(F) applies to "all transactions" including an extension of credit generally barred by IRC 4941(d)(1)(B) pursuant to, among other things, a redemption. The example given in Reg. 53.4941(d)-3(d)(2) provides insight into this matter:

"**Example (2)**. Private foundation Y ...acquires 60 percent of the

Class A preferred stock of corporation N by will on January 10, 1970. N ...is a disqualified person with respect to Y. In 1971, N offers to redeem all of the Class A preferred stock for a consideration equal to 100 percent of the face amount of such stock by the issuance of debentures....Both Y and all other holders of the Class A preferred stock accept the offer and enter into the transaction on January 2, 1972, at which time it is determined that the fair market value of the debentures is no less than the fair market value of the preferred stock. The transaction on January 2, 1972, shall not be treated as an act of self-dealing for 1972. However, because under. 53.4941(e)-1(e)(1)(i) an act of self-dealing occurs on the first day of each taxable year or portion of a taxable year that an extension of credit from a foundation to a disqualified person goes uncorrected, if such debentures are held by Y after December 31, 1972, except as provided in. 53.4941(d)-4(c)(4), such extension of credit shall not be excepted from the definition of an act of self-dealing by reason of the January 2, 1972, transaction."

Thus, the example above indicates that extensions of credit are not intended to be excepted under IRC 4941(d)(2)(F).

The installment sales in PLR 93-47-035 could also be self-dealing under IRC 4941(d)(1)(B). There is a prohibition on extensions of credit from a foundation to a disqualified person, and none of the specific exceptions to this rule apply in this case. Further, while the redemption exception to self-dealing under IRC 4941(d)(2)(F) may apply initially in this case, under the example in Reg. 53.4941(d)-3(d)(2), self-dealing violations under IRC 4941(d)(1)(B) arise each year because the extension of credit continues after the initial transaction.

If the installment sales are treated as sales of property under IRC 4941(d)(1)(A), then IRC 4941(d)(2)(F) may exempt the initial cash down payment for the shares of stock. However, each installment payment thereafter would then be a separate sale of property and a separate act of self-dealing under IRC 4941(d)(2)(A), not excepted by IRC 4941(d)(2)(F).

PLR 93-47-035, <u>supra</u>, is being revoked. <u>See</u> <u>also</u> D.(4)c., <u>infra</u>.

iv. <u>Redemptions and Other Reorganizations Without Loans</u>

An example of a redemption of stock which did not involve a loan is provided in Deluxe Corp v. United States, 885 F.2d 848 (Fed. Cir. 1989). In this case, a corporation conducted a redemption of its common stock. Some of the stock was owned by a private foundation. The corporation excluded its officers and directors from the redemption. The court concluded that the redemption met the exception in IRC 4941(d)(2)(F) because Reg. 53.4941(d)-3(d)(1) did not require shareholders who are officers or directors to be included in the redemption program, and the redemptions were no less than fair market value.

PLR 92-05-001 (September 12, 1991) describes the exchange of common stock owned by a private foundation for noncumulative preferred stock of a closely held corporation and indicated that the transaction was an act of self-dealing between the foundation and a disqualified person. The closely held corporation was a disqualified person because it was a substantial contributor to the private foundation, and more than 35 percent of its stock was owned by the family of the private foundation's manager. The transaction occurred by mutual agreement of the parties and was not excepted from the self-dealing provisions as a transaction pursuant to a merger or other corporate readjustment. The ruling also held that the act resulted in excess business holdings under IRC 4943 and was a jeopardizing investment under IRC 4944.

(g) Loans and IRC 4945

Although a loan may constitute an act of self-dealing under IRC 4941(d)(1)(B), the transaction does not necessarily also give rise to a taxable expenditure under IRC 4945. Rev. Rul. 77-161, 1977-1 C.B. 358, held that a loan by a private foundation to a disqualified person constituted an act of self-dealing under IRC 4941(d)(1)(B). However, the loan did not constitute a taxable expenditure within the meaning of IRC 4945(d)(5). The analysis under IRC 4945 was whether the loan would have been a proper expenditure for the foundation if it had not been an act of self-dealing. The loan was made to the disqualified person at a reasonable and otherwise prudent rate of interest, adequately secured, signed solely to provide income for the foundation's charitable purposes. Under Reg. 53.4945-6(b)(1)(i), the loan would have been a permissible expenditure for investment purposes. See 3.E., infra.

(h) Self-Dealing Loans and Other Tax Consequences

Loans which constitute acts of self-dealing under IRC 4941(d)(2)(B) may give rise to other tax consequences. See Rev. Rul. 80-271, 1980-2 C.B. 282, where a charitable trust did not qualify for a federal gift tax deduction under IRC 2522(a); the trust was treated as a private foundation under IRC 509(a), and the trustee was not prevented from exercising a power under which the trustee or a member of the settlor's family may borrow money from the trust. See also G.C.M. 38212 (December 20, 1979).

(i) Bottom Line

Transactions involving loans and other extensions of credit between a private foundation and a disqualified person should be carefully scrutinized.

(3) Furnishing of Goods, Services, and Facilities

a. General

IRC 4941(d)(1)(C) defines the term 'self-dealing' to include the furnishing of goods, services or facilities between a private foundation and a disqualified person. IRC 4941(d)(2)(D) provides that the furnishing of goods, services, or facilities by a private foundation to a disqualified person is not an act of self-dealing if the furnishing is made on a basis no more favorable than that on which the goods, services, or facilities are made available to the general public. However, after May 16, 1973, the exception set forth in IRC 4941(d)(2)(D) only applies if the goods, services, or facilities are functionally related within the meaning of IRC 4942(j)(5) to the exercise or performance by a private foundation of its charitable purposes, constituting the basis for its exemption under IRC 501(c)(3). Reg. 53.4941(d)-3(b)(1). Providing personal living quarters to a foundation manager or employee may be excepted from self-dealing. Reg. 53.4941(a)-2(d). Providing living quarters to a disqualified person providing custodial functions in an historic landmark has been held in letter rulings to be not an act of self-dealing. See PLR 89-14-034 (September 6, 1989).

b. Published Examples

Rev. Rul. 73-363, 1973-2 C.B. 383, provides that the rental of a charter aircraft by a disqualified person, the charter aircraft company, to a private foundation constituted an act of self-dealing under IRC 4941(d)(1)(C). The rental of a charter aircraft was a furnishing of property for use by the foundation and did not constitute the performance of personal services within the meaning of Reg. 53.4941(d)-3(c). Rather, the rental was analogous to the rental of automobiles and was therefore a furnishing of goods, services, or facilities as described in Reg.

53.4941(d)-2(d). The fact that the rate charged was comparable to rates charged by other aircraft companies was not a relevant factor.

The exception in IRC 4941(d)(2)(D) applied in Rev. Rul. 76-10, 1976-1 C.B. 355. A foundation's meeting room was available at no charge to members of the community-at-large. The room was made available to a government official, who was a disqualified person, on the same basis that it was made available to other community and civic groups. The use of the room for communications between the government official and members of the public was functionally related to the foundation's exempt purpose of making the room available for civic and community purposes. The ruling holds that the use of the foundation's meeting room by the government official does not constitute an act of self-dealing under IRC 4941(d)(1)(C).

In order for the exception in IRC 4941(d)(2)(D) to apply, the furnishing of goods, services, or facilities by the foundation must be functionally related to its exempt purposes. Rev. Rul. 76-459, 1976-2 C.B. 369, addresses the use of a private foundation museum's private road by a corporation that is a disqualified person. The corporation used the road for access to its adjacent headquarters and manufacturing plant, during the same hours the road was used by the general public as a thoroughfare connecting two public streets. The ruling stated that, generally, by permitting a disqualified person to use its private road, a private foundation would be engaging in an act of self-dealing. However, the road was made available to the corporation on a basis that was no more favorable than that on which it was available to the general public. Also, a substantial number of persons other than disqualified persons actually used the road. The fact that the corporation agreed to maintain the road did not entitle it to any special privileges with respect to the road. Further, the use of the road as an entrance to the foundation's museum was functionally related within the meaning of IRC 4942(j)(5) to the foundation's exempt purpose of operating a museum for the benefit of the general public. Thus, the ruling holds that the use of the foundation's private road by the corporation is not an act of self-dealing under IRC 4941(d)(1)(C).

In contrast, Rev. Rul. 79-374, 1979-2 C.B. 387, sets forth a scenario involving office space rented to disqualified persons. An exempt private foundation conducted agricultural economics research and experimentation in part of an office building it owned. The foundation rented the remaining spaces to disqualified persons who engaged in agricultural business activities. The foundation did not utilize these businesses in its research. The rental of the office space was not functionally related to the foundation's exempt purpose and constituted an act of self-dealing under IRC 4941(d)(1)(C).

(4) Payment of Compensation or Reimbursement of Expenses by the Foundation to a Disqualified Person

a. General

IRC 4941(d)(1)(D) provides that the term "self-dealing" includes any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person.

The payment of compensation or reimbursement of expenses by a foundation to a disqualified person is normally an act of self-dealing under IRC 4941(d)(1)(D). However, the payment of compensation or expenses is not an act of self-dealing if it is not excessive and the services performed are personal and are reasonable and necessary for the foundation's exempt purposes. IRC 4941(d)(2)(E).

b. Personal Services Exception

i. General

IRC 4941(d)(2)(E) has been referred to as the "personal services exception." Specifically, IRC 4941(d)(2)(E) provides that, except in the case of a government official (as defined in IRC 4946(c)), the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment) is not excessive. Further, the providing of goods, services and facilities to a foundation manager or employee as part of a reasonable compensation package may also be excepted from self-dealing. Reg. 53.4941(d)-2(d).

ii. Pensions

Rev. Rul. 74-591, 1974-2 C.B. 385, involves a pension for past personal services paid by a private foundation to one of its directors. The director was a disqualified person whose total compensation, including the pension, was not excessive. The ruling stated that the payment of pensions to retired employees has been recognized as an accepted method of employee compensation used by many public and private organizations. See Rev. Rul. 73-126, 1973-1 C.B. 220. The services performed by the disqualified person for the foundation represented personal services, excepted by IRC 4941(d)(2)(E), that were reasonable and necessary in carrying out the exempt functions of the foundation. Thus, the ruling holds that the pension does not constitute an act of self-dealing under IRC 4941.

c. Scope of Personal Services

A recent concern regarding the personal services exception is whether it is correctly applied to an ever-increasing variety of transactions. The regulations provide some guidance in this respect. Reg. 53.4941(d)-2(c)(4) provides that the performance of certain general banking services is an exception to the general rule prohibiting the lending of money between a private foundation and a disqualified person under IRC 4941(d)(1)(B). These general banking services are within the scope of the personal services which do not constitute self-dealing transactions under IRC 4941(d)(2)(E). The regulation further explains that the general banking services that are allowed are: 1) checking accounts, as long as the bank does not charge interest on any withdrawals; 2) savings accounts, as long as the foundation may withdraw its funds on no more than 30-days notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit; and 3) safe-keeping activities. As we noted in section B.(2)d. above, loans made as part of a compensation package are currently being scrutinized, and may not qualify as a "personal service" exception.

Reg. 53.4941(d)-3(c)(1) provides, in part, an exception for "personal services which are reasonable and necessary to carry out the exempt purpose of the private foundation" so that payment to a disqualified person for the service will not be an act of self-dealing as long as the payment is not excessive. The regulation states that the term 'personal services' includes the services of a broker serving as agent for the private foundation, but not the services of a dealer who buys from the private foundation as principal and resells to third parties. The regulation further states that any payment representing payment for property will not be treated as falling within this exception.

Reg. 53.4941(d)-3(c)(2) provides some examples of legal services, investment services, and banking services of savings and checking accounts and safety deposit boxes provided by disqualified persons that come within the exception for personal services when they are reasonable and necessary to carry out exempt purposes. It also provides an example explaining that payment under a contract with a disqualified person for the manufacturing of microscopes is not payment of compensation for the performance of personal services; therefore, the transaction constitutes an act of self-dealing.

Thus, the regulations indicate that brokering, legal, investment, and certain banking services are acceptable, whereas the selling of manufactured goods by a disqualified person to a private foundation is not a personal service. The personal services of an accountant would also generally be treated similar to the personal services of a lawyer. Also, the payment of compensation to a disqualified person meets the exception provided two factors are met: 1) the services are necessary to further the exempt purposes of the foundation, and 2) the compensation is reasonable.

In addition to the examples in the regulations, there are several Revenue Rulings which are helpful in providing guidance with respect to the types of transactions that fall within the personal services exception to self-dealing transactions. Rev. Rul. 73-546, 1973-2 C.B. 384, holds that the payment by a private foundation to a bank, a disqualified person, of a service fee for an overdrawn checking account did not result in an act of self-dealing under IRC 4941, by reason of IRC 4941(d)(2)(E). The amount of the service fee was equal to the actual cost of processing the overdraft. The fee was part of the compensation paid by the foundation to the bank for the maintenance of its checking account. As the service fee equaled the actual expense of processing the amount overdrawn, it was not excessive under Reg. 53.4941(d)-2(c)(4).

In contrast, Rev. Rul. 73-595, supra, held that there was self-dealing with respect to a savings account with a disqualified person, not excepted by IRC 4941(d)(2)(E), because of the loss of interest. Also, Rev. Rul. 77-259, 1977-2 C.B. 387, provides that a private foundation's purchase of a mortgage from a bank constituted an act of self dealing under IRC 4941. The bank was considered to be a disqualified person with respect to the foundation. In the normal course of its business, the bank acquired and sold mortgages. The reason that the transaction did not fall under the personal services exception in IRC 4941(d)(2)(E) was that the bank was the holder of the mortgage note and thus was not performing personal services as the agent for the foundation when it sold the note to the foundation. Also, the sale of a mortgage was not a general banking function specifically excluded from classification as an act of self-dealing under Reg. 53.4941(d)-2(c)(4).

Rev. Rul. 77-288, 1977-2 C.B. 388, holds that a private foundation's purchase of certificates of deposit from a bank, which is a disqualified person, was an act of self-dealing. The certificates of deposit did not qualify as a general banking function under Reg. 53.4941(d)-2(c)(4) because the foundation would suffer a loss if it withdrew funds prior to the maturity date. Thus, the purchase of certificates of deposit from the bank is considered a lending of money by the private foundation to the disqualified person. See also G.C.M. 39547 (August 22, 1986).

Rev. Rul. 73-613, 1973-2 C.B. 385, involves a private foundation's payment of legal fees awarded by a court to the counsel for its director-manager, a disqualified person. The director had filed suit against the remaining directors to require them to carry on the foundation's charitable program. The issue was whether a self-dealing violation under IRC 4941(d)(1)(D) occurred (any direct or indirect payment of compensation or payment or reimbursement of expenses by a private foundation to the disqualified person). Since the purpose of the suit was to provide a means for the foundation to renew its operations and carry out its charitable program, the service performed by the director was reasonable and necessary to carry out the exempt purpose of the foundation. Thus, the payment does not constitute an act of self-dealing because it meets the exception in IRC 4941(d)(2)(E).

The above revenue rulings clarify, in particular, the types of services relating to general banking services. However, there has been some debate regarding whether the regulations contemplate all services which are considered to meet the personal services exception, or whether there are other kinds of services, not specifically referred to by the regulations, which can also fall under the personal services exception. If there are other kinds of services which will meet the personal services exception, then the issue is what kinds of services, not listed in the regulations, will meet the exception. For example, can such activities as secretarial services, property repair and maintenance services fall within the exception?

PLR 93-25-061 (April 1, 1993) sets forth facts in which the Service declined to apply the personal services exception, ruling that the proposed transaction would result in self-dealing. The transaction involved commercial property management services provided to the foundation by a number of disqualified persons. This ruling was affirmed by PLR 94-04-032. PLR 92-26-067 (March 31, 1992) concluded that a property management service provided by a disqualified person did not constitute a self-dealing transaction, because it met the personal services exception under Reg. 53.4941(d)-3(c). The latter PLR was reconsidered, additional facts were reviewed, and the PLR was affirmed in a yet to be numbered PLR (May 23, 1994) since the management services were not commercial and were part of the administrative functions of the foundation manager.

d. Excessive and Other Compensation Issues

In Kermit Fischer Foundation v. Commissioner, supra, the court held that the foundation was liable for the IRC 4941(a) tax for receipt of excessive compensation. The manager received annual compensation of up to $45,400 from a foundation whose assets never exceeded $211,000. The court held that all compensation in excess of $2,000 per year was subject to the initial tax on self-dealing. See also 1993 CPE, p. 200. For treatment of indemnification insurance as compensation for foundation managers, see 2.E., infra.

e. Bottom Line

Each case involving the personal services exception and not involving foundation managers and foundation employees should be carefully scrutinized if the "service" is not one listed in the regulations. The personal services exception under IRC 4941(d)(2)(E) is a special rule that should be strictly construed in light of the intention of Congress, in areas of self-dealing, to generally provide a blanket prohibition on insider transactions as opposed to instituting an arms length standard of review. "This is based on the belief by Congress that the highest fiduciary standards require complete elimination of all self-dealing rather than arms length standards." General Explanation of The Tax Reform Act of 1969, p. 31 (December 3, 1970), prepared by the Staff of the Joint Committee on Internal Revenue Taxation.

(5) Transfer to, or Use by or for the Benefit of, a Disqualified Person of the Income or Assets of the Private Foundation

a. General

IRC 4941(d)(1)(E) defines " self-dealing" as any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

b. Incidental and Tenuous Exception

Reg. 53.4941(d)-2(f)(2) states that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing. Thus, the public recognition a person may receive, arising from the charitable activities of a private foundation to which such person is a substantial contributor, does not in itself result in an act of self-dealing since generally the benefit is incidental and tenuous. See example (4) of Reg. 53.4941(d)-2(f)(4) and Rev. Rul. 73-407, 1973-2 C.B. 383. The revenue ruling holds that a contribution by a private foundation to a public charity made on the condition that the public charity change its name to that of a substantial contributor to the foundation and agree not to change the name again for 100 years did not constitute an act of self-dealing under IRC 4941(d)(1)(E). The benefit to the disqualified person was incidental and tenuous.

In contrast, Rev. Rul. 77-160, 1977-1 C.B. 351, addressed the payment by a private foundation of a disqualified person's church membership dues in order to maintain that person's church membership. The ruling stated that when membership fees or dues are paid by a private foundation on behalf of a disqualified person, it may be presumed that the disqualified person is being relieved of the obligation, whether or not legally enforceable, to make such payment. The benefit conferred on the individual is not incidental or tenuous, but rather is direct and economic in nature. Therefore, the payment of membership dues was an act of self-dealing under IRC 4941(d)(1)(E). Foundation contributions to public charity cultural events that pay for disqualified persons to attend may constitute self-dealing. See PLR 90-21-065 (March 1, 1990). More examples of the incidental and tenuous exception follow below.

c. Examples of Disqualified Person Use of Private Foundation Assets

i. Art Use

Rev. Rul. 74-600, 1974-2 C.B. 385, holds that the placing of paintings owned by a private foundation in the residence of a substantial contributor, a disqualified person, constitutes an act of self-dealing under IRC 4941(d)(1)(E). Although the foundation's paintings were sometimes made available for public viewing, this placement in the residence of the disqualified person resulted in a direct use of the foundation's assets by or for the benefit of the disqualified person. For thorough discussions of shared use or predominant use of private foundation art assets by disqualified persons, see G.C.M. 39741 (June 20, 1988) and G.C.M. 39770 (December 15, 1988).

ii. Earmarked Grants to Public Charities (See also 2.C.(4), infra)

Rev. Rul. 75-42, 1975-1 C.B. 359, involves a grant authorized by a private foundation to an exempt hospital for modernization, replacement, and expansion. Two individuals served as trustees of both organizations. IRC 53.4941(d)-2(f)(2) provides, as an example, that a grant by a private foundation to an IRC 509(a)(1), (2) or (3) organization will not be an act of self-dealing merely because one of the IRC 509(a)(1), (2), or (3) organization's officers, directors, or trustees is also a manager of or a substantial contributor to the foundation. Since any benefit to disqualified persons (two trustees herein) was incidental, the grant program did not constitute self-dealing within the meaning of IRC 4941(d)(1)(E). This revenue ruling was clarified by Rev. Rul. 82-136, 1982-2 C.B. 300. The ruling holds that a grant by a private foundation to a second private foundation did not constitute an act of self-dealing within the meaning of IRC 4941 even though a banking institution served as sole trustee of both foundations. Regarding expenditure responsibility, the foundation must exercise expenditure responsibility over the grant as required by IRC 4945(d)(4) and IRC 4945(h) and the regulations thereunder. See 3.D., infra.

iii. Income Used to Pay DP Legal Obligations

In Rev. Rul. 77-331, 1977-2 C.B. 388, a private foundation guaranteed loans made to disqualified persons under a student loan guarantee program. The program was established by the foundation for the children of its employees. Each time a loan made to a disqualified person was guaranteed with funds granted by the private foundation, the income or assets of the foundation were being used indirectly to satisfy the legal obligation of a disqualified person. See Reg. 53.4941(d)-(f)(1). Such use of the foundation's income or assets conferred more than an incidental or tenuous benefit upon the disqualified persons involved. Thus, the guarantee of loans made to disqualified persons constituted an act of self-dealing within the meaning of IRC 4941(d)(1)(E).

iv. Segregated Guarantees

Rev. Rul. 77-6, 1977-1 C.B. 350, involves the purchase of a portion of a bond issue on behalf of an exempt hospital by a disqualified person. The private foundation guaranteed the bonds except for those sold to the disqualified person. Because the guarantee did not apply to bonds purchased by the disqualified person, the arrangement did not result in any use of the foundation's assets for the economic benefit of the disqualified person. Moreover, any benefit derived by the disqualified person by virtue of that person's position as an officer of the hospital was incidental or tenuous within the meaning of Reg. 53.4941(d)-2(f)(2). Thus, the transaction was not an act of self-dealing within the meaning of IRC 4941(d)(1)(E).

v. Charitable Programs with Incidental Private Benefit

In Rev. Rul. 80-310, 1980-2 C.B. 319, a private foundation made a grant to a university to establish an educational program in manufacturing engineering. The program benefited a corporation that was a disqualified person. The corporation benefited from the program only in an incidental manner as one of many manufacturing businesses that could benefit from the skills acquired by the students in the program. The ruling analogized the situation to the slum clearance program described in Example (1) of Reg. 53.4941(d)-2(f)(4). The educational program was of broad public interest to the community. Since any benefit to the corporation was incidental, the grant does not constitute an act of self-dealing within the meaning of IRC 4941.

Rev. Rul. 85-162, 1985-2 C.B. 275, discusses a loan program of a private foundation. The program provided financing to publicly supported organizations for construction projects in disadvantaged areas. Certain individuals involved in the construction projects had ordinary banking and business relationships with a bank that was a disqualified person. The ruling contemplated the possible benefit to the bank or other disqualified persons arising from an ordinary banking and business relation with a contractor, subcontractor, supplier, or an employee of the parties in the construction projects. The ruling concluded that such benefit would be incidental or tenuous within the contemplation of Reg. 53.4941(d)-2(f)(2). Thus, the loan program did not result in acts of self-dealing within the meaning of IRC 4941.

In Underwood v. United States, 461 F. Supp. 1382 (N.D. Tex. 1978), the making of a charitable contribution to a private foundation, on the condition that the nondeductible portion of the gift would be returned to the disqualified persons, was not an act of self-dealing.

(6) Agreement by the Private Foundation to Make Any Payment to a Government Official, Other Than an Agreement to Employ the Official After Termination of His Government Service if He is

Terminating His Service Within a 90-day Period

a. General

IRC 4941(d)(1)(F) generally provides, with the above exception, that an act of self-dealing occurs if a private foundation makes any payment of money or other property to a government official.

b. Domestic Travel

An exception to this general prohibition is found in IRC 4941(d)(2)(G)(vii) which permits a private foundation (within certain limitations) to pay or reimburse a government official for traveling expenses incurred for travel solely from one point in the United States to another point in the United States.

Rev. Rul. 77-251, 1977-2 C.B. 389, provides that a per diem allowance for travel inside the U.S. paid to a government official by a private foundation in connection with its educational and charitable purposes is excepted from the tax on self-dealing under IRC 4941(d)(2)(G)(vii) only if the allowance does not exceed 125 percent of the maximum authorized rate provided by section 5702(a) of title 5, U.S.C., notwithstanding the provision in section 5702(c) allowing higher rates in designated geographical areas.

c. Foreign Travel

Rev. Rul. 74-601, 1974-2 C.B. 385, provides that the reimbursement by a private foundation for travel, meals, and lodging expenses incurred by U.S. Congressmen it chooses to participate in a conference it cosponsors in a foreign country does not come within the exception to self-dealing set forth in IRC 4941(d)(2)(G)(vii). Since the payments in question are not for travel solely from one point in the United States to another point in the United States, they do not come within the exception to self-dealing set forth in IRC 4941(d)(2)(G)(vii). Further, since Members of Congress are government officials within the meaning of IRC 4946(c)(1), the payments or reimbursement of such expenses would constitute acts of self-dealing within the meaning of IRC 4941(d).

d. Puerto Rico Travel

Rev. Rul. 76-159, 1976-1 C.B. 356, holds that the payment or reimbursement by a private foundation of expenses incurred by a trustee, a government official of the Commonwealth of Puerto Rico, for roundtrip travel from Puerto Rico to the U.S. to attend the foundation's trustee meetings does not constitute an exception to self-dealing under IRC 4941(d)(2)(G)(vii). See G.C.M. 36217 (March 28, 1975).

e. GS Scale Pay

See also earlier discussion on GS scale pay (Section A.(2)f.) above.

C. Indirect Acts of Self-Dealing

(1) General

Transactions involving a private foundation may involve more than two entities, such as multiple corporations, many of which could acquire disqualified person status through attribution rules provided by IRC 4946(a)(1)(E), (F), (G), and IRC 4946(a)(3) and (4). See A.(2)c. and e. above. Even though there may be an entity interposed between a private foundation and a disqualified person, IRC 4941(d) prohibits indirect as well as direct acts of self-dealing. The term "indirect self-dealing" includes any transaction between a disqualified person and an organization "controlled" by a private foundation within the meaning of Reg. 53.4941(d)-1(b)(5). Reg. 53.4941(d)-1(b)(1).

In contrast, transactions with certain organizations do not constitute indirect self-dealing. A transaction between a private foundation and an organization which is not controlled by the foundation, and which is not described in IRC 4946(a)(1)(E), (F), or (G) because persons described in IRC 4946(a)(1)(A), (B), (C), or (D) own no more than 35 percent of the total combined voting power or profits or beneficial interest of such organization, is not an indirect act of self-dealing between the foundation and the disqualified persons solely because of the ownership interest of these persons in the organization. Reg. 53.4941(d)-1(b)(4).

(2) Controlled Organizations

Reg. 53.4941(d)-1(b)(5) provides, for purposes relative to acts of indirect self-dealing under IRC 4941(d), two basic tests for determining whether an organization is "controlled" by a private foundation. There is control: (1) if the foundation or one or more of its foundation managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute self-dealing; or (2) in the case of a transaction between the organization and a disqualified person, if the disqualified person, together with one or more disqualified persons, may, only by aggregating their votes or positions of authority with that of the private foundation, require the organization to engage in a transaction. The regulation also provides that an organization will be considered to be controlled by a private foundation or by a private foundation and disqualified persons if such persons are able, in fact, to control the organization (even if their aggregate voting power is less that 50 percent of the total voting power of the organization's governing body) or if one or more of such persons has the right to exercise veto power over the actions of the organization relevant to any potential acts of self-dealing.

See G.C.M. 36452 (October 3, 1975) which indicates that control exists under the above regulation if: 1) the private foundation alone can control the organization; 2) the private foundation, by aggregating its votes or positions of authority with those of one or more foundation managers (acting only in such capacity) can control the organization; 3) a foundation manager (acting only in such capacity) alone can control the organization; or 4) the foundation managers (acting only in such capacity), by aggregating their votes or positions of authority with one another, can control the foundation. The key phrase "acting only in such capacity" refers to a situation in which a foundation manager has some form of control over a corporation solely because of his position as a foundation manager. The fact that the foundation manager personally owns stock in a corporation is not relevant in applying the regulation. See Rev. Rul. 76-158, 1976-1 C.B. 354. However, facts should still be fully analyzed to ensure that the corporation is not being used as an agent conduit in a step transaction that ultimately enriches disqualified persons. Also, and generally, private foundations remain subject to the IRC 501(c)(3) inurement prohibition. See 4.C., infra.

For an example of self-dealing involving multiple entities, see Adams v. Commissioner, supra. The case involved a disqualified person, the trustee of a private foundation, who owned a corporation. The corporation owned by the trustee transferred two encumbered properties to the wholly owned subsidiary of the private foundation. The court held that the sale of the property constituted self-dealing. See also PLR 93-25-061 (April 1, 1993).

Indirect acts of self-dealing do not include any transaction between a disqualified person and an organization controlled by a private foundation if (a) the transaction results from a business relationship which was established before the transaction constituted an act of self-dealing; (b) the transaction is at least as favorable to the organization controlled by the private foundation as an arm's-length transaction with an unrelated party; and (c) either (i) the organization controlled by the foundation could engage in the transaction with someone other than a disqualified person only at a severe economic hardship to such organization, or (ii) because of the unique nature of the product or services provided by the organization controlled by the foundation, the disqualified person could not have engaged in the transaction with anyone else, or could have done so only by incurring severe economic hardship. Reg. 53.4941(d)-1(b)(1).

PLRs 92-22-057 and 92-22-058 (March 6, 1992) held that an exempt private foundation did not engage in an indirect act of self-dealing with respect to a plan proposed by its substantial corporate contributor to form a partnership with members of the foundation's board of directors. Neither the corporation nor the other organizational party to the partnership was controlled by the foundation, as the term is defined in Reg. 53.4941(d)-1(b)(5). See PLR 92-04-053 (October 31, 1991) for discussion of control issue involving an IRC 4947(a)(2) trust and corporate stock interests held in disqualified person's estate.

(3) Transactions Involving Limited Amounts

The term 'indirect self-dealing' does not include any transaction between a disqualified person and an organization controlled by a private foundation, or between two disqualified persons where the foundation's assets may be affected by the transaction if--

1) The transaction arises in the normal and customary course of a retail business engaged in with the general public,

2) In the case of a transaction between a disqualified person and an organization controlled by a private foundation, the transaction is at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person, and

3) The total of the amounts involved in such transactions with respect to any one such disqualified person in any one taxable year does not exceed $5,000. Reg. 53.4941(d)-1(b)(6). See also example (7) of Reg. 53.4941(d)-1(b)(8).

(4) Earmarking

a. Earmarking and the Government Official Exception

The 1994 CPE Textbook (p. 150 et. seq.) discussed the Service concerns with exempt organizations channeling funds through "fiscal sponsors" such as public charities to avoid, for example, the self-dealing prohibitions and the expenditure responsibility requirements imposed on private foundations under IRC 4945.

The term 'indirect self-dealing' also does not include a transaction engaged in with a government official by an intermediary organization which is a recipient of a grant from a private foundation and which is not controlled by the foundation if the private foundation does not earmark the use of the grant for any named government official and there does not exist an agreement, oral or written, whereby the grantor foundation may cause the selection of the government official by the intermediary organization. A grant by a private foundation is earmarked if such grant is made pursuant to an agreement, either oral or written, that the grant will be used by any named individual. Thus, a grant by a private foundation does not constitute an indirect act of self-dealing even though such foundation had reason to believe that certain government officials would derive benefits from such grant so long as the intermediary organization exercises control, in fact, over the selection process and actually makes the selection completely independent of the private foundation. Reg. 53.4941(d)-1(b)(2). See also example (3) of Reg. 53.4941(d)-1(b)(8) and G.C.M. 38904 (October 6, 1982).

b. PLR 94-21-039

PLR 94-21-039 (February 28, 1994) is a recent Service ruling that raises the earmarking issue in the context of section 4941 (and 4945). It provides a description of how appearances of impropriety can be prudently avoided. We extract salient portions:

FACTS

E is a charitable trust exempt under section 501(c)(3) of the Code and classified as a private foundation under section 509(a). Two of E's trustees, A and B, are disqualified persons with respect to E by virtue of being E's foundation managers.

M is a charitable trust exempt under section 501(c)(3) of the Code and classified as a public charity under section 509(a)(3). A and B are two of the five trustees of M. M's supported organizations are N and O.

N is exempt under section 501(c)(3) of the Code and classified as a publicly supported organization under section 170(b)(1)(a)(vi). Its three broad charitable objectives are conservation, education and environmental advocacy. In furtherance of its purpose, N owns certain property which it operates as a wildlife sanctuary.

P is a piece of property owned by A and B. P is adjacent to N's wildlife sanctuary. A and B plan to partition portions of P in such a way that each becomes the sole owner of a separate portion. B's portion of the property will be about 410 acres of undeveloped land with unique habitats that are not present on N's sanctuary. In order to expand its facilities and thus, add various forms of aquatic life and other species to its protection program, N proposes to purchase B's separate portion of P. The subject property has been appraised by an independent third party appraiser. The purchase price will be approximately X dollars.

Over the years, E has awarded M a number of grants totalling over Y dollars, which has enabled M to make major grants to N for purchases of property from A and B. See, LTR 8710095 (December 11, 1986), LTR 9009067 (December 11, 1989). E also received an earlier letter from the Service involving a grant from E to Q that was used by Q to charter a research vessel from a corporation whose sole shareholder was a disqualified person in respect to E. None of the letters noted above, issued by the Service to E, are being reviewed by the Service.

Within the last year, E has made a grant of Z dollars to M. Currently, M is considering making a grant of approximately Z dollars to N. The grant may be used by N for any purpose set forth in section 170(c)(2)(B) of the Code. N will not use the grant money to purchase B's property. N will maintain the grant funds in a separate account until the first to occur of: (i) complete expenditure by N of the granted funds; (ii) the purchase by N of B's portion of the partition property using funds other than the granted funds; or (iii) the expiration of two years from the date of M's grant if no agreement is made within such two year period for the purchase and sale of such property to N. A and B will not participate in M's grant determination. B and N plan to negotiate a binding Purchase and Sales Agreement under which N will agree to purchase B's 410 acres in cash. N will purchase B's property using independent sources of funds; the Z dollar grant from M will not be used. E assumes that M will grant the Z dollars to N prior to a sale of B's property to N.

E has specifically requested rulings as to whether these proposed transactions would result in an act of self-dealing under section 4941 of the Code or a taxable expenditure under section 4945 of the Code.

RATIONALE AND CONCLUSIONS

Congress, in enacting section 4941 of the Code, intended to replace the then existing arms-length standards regarding certain self-dealing transactions with a general prohibition on such transactions. S. Rep. No. 91-552, 91st Cong., 1st Sess. 28-29 (1969), 1969-3 CB 442-443.

Indirect self dealing is not defined in section 4941 of the Code or the regulations thereunder. It was not feasible to draft a comprehensive definition because of the great variety of possible situations which could be called indirect self-dealing. Memorandum dated December 5, 1972 from Johnnie M. Walters, Commissioner, to the Assistant Secretary for Tax Policy (T.D. 7270. LR-1611) as noted in G.C.M. 39445, July 11, 1985. Instead, the regulations provide four examples of situations that do not constitute indirect self-dealing.

Section 53.4941(d)-1(b) of the regulations provides four exceptions in areas which otherwise would be considered indirect self-dealing. One of the exceptions under section 53.4941(d)-1(b)(2) provides for an intermediaries exception that is limited to government officials, a separate and distinct class of disqualified persons under section 4946 of the Code. Government officials do not otherwise have a vested familial or economic interest with a related private foundation. There is no stated exception from indirect self-dealing under the regulations for private foundation grants to intermediary organizations where other types of disqualified persons are involved similar to the special exception and example describing government officials under section 53.4941(d)-1(b) of the regulations. Indirect self-dealing, therefore, may result in transactions between other disqualified persons and intermediary organizations which involve the use of private foundation assets. Otherwise, an intermediary organization could be used to avoid section 4941 and thereby undermine Congressional intent to prohibit self-dealing.

In this case, the facts do not reveal a prohibited earmarking situation. E's Z dollar grant to M will not constitute a direct act of self-dealing under section 4941 of the Code and its underlying regulations because the transaction is between E and a public charity. Section 53.4946-1(a)(8) of the regulations, supra. M's contribution to N also would not be a direct act of self-dealing. Further, the sale of B's property to N will not constitute a direct or indirect act of self dealing because E's Z dollar grant to M will not be used for the acquisition of B's land. The Z dollar grant has not been earmarked for the purchase of B's property. M has restricted the use of the grant funds to N's general charitable purposes. N will use separate funds of its own to purchase B's land.

Under section 4945 of the Code and the underlying regulations, favorable resolution is warranted following the approach under section 4941 discussed above. E's situation is further buttressed by analogy to the regulations and examples under section 53.4945-2(a) as amended by T.D. 3808, filed August 30, 1990. These regulations concern grants by private foundations to public charities who have made the lobbying election under section 501(h) of the Code. Addressing facts similar to those describing E's grant to M and the subsequent actions of M and N, the section 53.4945-2(a) regulations would not hold that the general purpose grants made by private foundations to electing charities that lobby within the permissible parameters of section 501(h) and 4911 constitute taxable expenditures. Since N will have sufficient and separate funds of its own to acquire B's land, it would not be appropriate to raise any attribution to E's original grant to M.

Based on the information furnished, we rule as follows:

1. The sale of B's property to N will not constitute a direct or indirect act of self-dealing for purposes of section 4941 in respect to E and its disqualified persons.

2. E's grant to M of Z dollars would not constitute a taxable expenditure within the meaning of section 4945(d) of the Code.

3. E does not have to exercise expenditure responsibility within the meaning of section 4945(h) of the Code with respect to the Z dollar grant to M.

c. Rev. Rul. 75-42

In Rev. Rul. 75-42, supra, it was held that a grant authorized by a private foundation to a public charity hospital for modernization, replacement, and expansion does not constitute an act of self-dealing even though two individuals served as trustees of both organizations. Following Regs. 53.4941(d)-2(f)(2), Rev. Rul. 75-42 reasoned that the benefit to the trustees was incidental and tenuous.

Rev. Rul. 75-42 would likely have a different conclusion if facts indicated that the hospital contracted with companies owned by the two trustees to perform the modernization, replacement, and expansion projects. Compare also to Rev. Rul. 85-162, 1985-2 C.B. 275, discussed in section B.(5)c.v. above.

d. Bottom Line

The Service will review general purpose grants made by private foundations to public charities if facts reveal that the latter expended funds contemporaneously for projects that if funded directly by private foundation grantors would constitute self-dealing acts. There would be no attribution issues raised if there were no oral or written agreements between the parties and there was evidence that the public charities had independent funds sufficient to cover the costs of the projects.

(5) Administration of Estate Exception

Reg. 53.4941(d)-1(b)(3) provides rules regarding transactions that do not constitute indirect acts of self-dealing during the administration of an estate or trust. This is an important exception that is the subject of many PLRs. See, e.g., PLR 92-39-037 (June 30, 1992). Rockefeller v. United States, 572 F. Supp. 9 (E.D. Ark. 1982), aff'd, 718 F.2d 290 (8th Cir. 1983), cert. den., 466 U.S. 962 (1984), involved judicial review of the constitutionality of Reg. 53.4941(d)-1(b)(3). Winthrop Rockefeller died on February 22, 1973. Decedent left the residue of his estate to a charitable trust created under his will. The will contemplated that certain stock would constitute a substantial part of the trust. On September 30, 1975, decedent's son purchased the stock from the estate that would have been transferred to the trust. The purchase price of the stock was determined by independent appraisal of the fair market value of the stock. The sale was also subject to probate court approval. The Service determined that the trust was a private foundation and that the son was a disqualified person with respect to the trust. Thus, the purchase of stock was an act of self-dealing between the son and the trust, where the fair market value of the stock was greater than the amount paid to the estate. The court held that the purchase constituted an indirect act of self-dealing.

(6) Commonality with Direct Self-dealing Exceptions

Indirect self-dealing does not include any acts which a private foundation could engage in by reason of IRC 4941(d)(2) (exceptions to direct acts of self-dealing in 4941(a)).

D. Computation of Tax

(1) The First Tier

a. General

IRC 4941(a)(1) imposes an initial excise tax on each act of self-dealing between a disqualified person and a private foundation. Except in the case of a government official, this tax is imposed on a disqualified person even though he or she had no knowledge at the time of the act that the act constituted self-dealing. Reg. 53.4941(a)-1(a).

The tax imposed by IRC 4941(a)(1) is at the rate of 5 percent of the amount involved (as defined in IRC 4941(e)(2) and Reg. 53.4941(e)-1(b)) with respect to the act of self-dealing for each year or partial year in the taxable period (as defined in IRC 4941(e)(1)). The tax is paid by any disqualified person (other than a foundation manager acting only in the capacity of a foundation manager) who participates in the act of self-dealing. However, if a foundation manager is also acting as a self-dealer, he or she may be liable for both the tax imposed by IRC 4941(a)(1) and by IRC 4941(a)(2). G.C.M. 39066 (November 25, 1983) indicates that the tax is imposed annually, rather than only with respect to the year in which the self-dealing violation occurred.

The tax is imposed upon a government official who participates in an act of self-dealing, but only if he or she knows that the act is an act of self-dealing. See Reg. 53.4941(a)-1(b)(3) for a definition of 'knowing'.

b. Manager Tax

IRC 4941(a)(2) imposes an excise tax on the participation of any foundation manager in an act of self-dealing between a disqualified person and a private foundation. This tax is imposed only in cases in which the following circumstances are present:

1) A tax is imposed by IRC 4941(a)(1),

2) The participating foundation manager knows that the act is an act of self-dealing, and

3) The participation by the foundation manager is willful and is not due to reasonable cause.

See PLRs 92-30-001 (March 12, 1992) and 93-35-001 (September 13, 1993). See also Thorne v. Commissioner, 99 T.C. 67 (1992) and section 3.F.(1).

The tax imposed by IRC 4941(a)(2) is at the rate of 2 1/2 percent of the amount involved with respect to the act of self-dealing for each year or partial year in the taxable period and shall be paid by any foundation manager described in subdivisions (ii) and (iii) above. Reg. 53.4941(a)-1(b)(1).

(2) The Second Tier

a. General

IRC 4941(b)(1) imposes an excise tax in any case in which an initial tax is imposed by IRC 4941(a)(1) on an act of self-dealing by a disqualified person with a private foundation and the act is not corrected within the taxable period (as defined in Reg. 53.4941(e)-1(a)). The tax imposed by IRC 4941(b)(1) is at the rate of 200 percent of the amount involved and shall be paid by any disqualified person (other than a foundation manager acting only in the capacity of a foundation manager) who participated in the act of self-dealing. Reg. 53.4941(b)-1(a).

b. Manager Tax

IRC 4941(b)(2) imposes an excise tax to be paid by a foundation manager in any case in which a tax is imposed by IRC 4941(b)(1) and the foundation manager refused to agree to part or all of the correction of the self-dealing act. The tax imposed by IRC 4941(b)(2) is at the rate of 50 percent of the amount involved and shall be paid by any foundation manager who refused to agree to part or all of the correction of the self-dealing act. Reg. 53.4941(b)-1(b). For the limitations on liability of a foundation manager, see Reg. 53.4941(c)-1(b).

(3) The Third Tier

a. General

IRC 507(a)(2) provides that the status of any organization as a private foundation shall be terminated if (A) with respect to such organization, there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under chapter 42, and (B) the Secretary notifies such organization that, by reason of subparagraph (A), such organization is liable for the tax imposed by subsection (c), and either such organization pays the tax imposed by subsection (c) (or any portion not abated under subsection (g)) or the entire amount of such tax is abated under subsection (g).

IRC 507(c) imposes on each organization the private foundation status of which is terminated under IRC 507(a) a tax equal to the lower of (1) all of the income, estate, and gift tax benefits (with interest) received by the foundation and any of its substantial contributors since 1913, or (2) the value of its net assets.

Thus, the third tier of IRC 4941 is termination and imposition of the termination tax. Termination does not negate the imposition of the IRC 4941 tax. See PLR 93-35-001 (April 27, 1993). For a discussion of IRC 507(a)(2) terminations, see the 1989 CPE, at page 113.

b. The Courts and IRC 507 Termination

There are few instances where involuntary termination under IRC 507(a)(2) have been judicially reviewed. Peters v. U.S., 80-2 U.S.T.C. 9148 (1980); George F. Harding Museum v. U.S., 674 F. Supp. 1323 (1988). In any case, it serves as a warning against abuse and a Service remedy to ensure that charitable assets are used for charitable purposes. See also 4.C., infra.

(4) Application of Tax

a. General

Reg. 53.4941(e)-1(e)(1)(i) states, with respect to the leasing of property, the lending of money or other extension of credit, other use of money or property, or payment of compensation, that, for purposes of IRC 4941, the transaction will generally be treated as giving rise to an act of self-dealing on the day the transaction occurs and on the first day of each taxable year or portion thereof which is within the taxable period and which begins after the taxable year in which the transaction occurs.

Taxable period is defined in IRC 4941(e)(1) as the period beginning with the date on which the act of self-dealing occurs and ending on the earlier of the date of mailing of a notice of deficiency with respect to the tax imposed by IRC 4941(a)(1), or the date on which correction of the act of self-dealing is completed.

Reg. 53.4941(e)-1(b)(2)(ii) states that where the use of money is involved, the amount involved shall be the greater of the amount paid for such use or the fair market value of such use for the period for which the money is used.

b. Different Tax Years

Rev. Rul. 75-391, 1975-2 C.B. 446, holds that a disqualified person with a tax year differing from that of the private foundation from which he borrows money computes the initial tax on self-dealing based upon his own tax year. See G.C.M. 35954 (August 19, 1974).

c. Computation

The computation of the tax on self-dealing requires ascertaining the amount involved. Reg. 53.4941(e)-1(e)(1) provides that there is one act of self-dealing for purposes of a single transaction, such as a sale. However, where the transaction is of a continuing nature such as a loan, the regulations provide that an act of self-dealing occurs on the day the transaction takes place and an additional act of self-dealing is deemed to occur on the first day of each subsequent taxable year or partial taxable year until corrected. Thus, in installment payment self-dealing acts (see PLR 93-47-035, discussed in B.(2)f.iii. above), the tax is imposed on the amount of the outstanding principal on the first day of each year. See Reg. 53.4941(e)-1(e)(1) and G.C.M. 39424 (October 23, 1985).

E. Discussion of Final Regulations (December 30, 1992) with Respect to Indemnification Insurance

(1) General

The payment by a private foundation of the premiums for an insurance policy providing liability insurance to a foundation manager for taxes imposed under Chapter 42 of the Code is considered to be an act of self-dealing unless the premiums are treated as part of the compensation paid to the manager. Reg. 53.4941(d)-2(f)(1).

The indemnification by a private foundation of a foundation manager, with respect to his defense in a judicial or administrative proceeding involving either Chapter 42 or state laws relating to mismanagement of funds of charitable organizations, against all expenses (other than taxes, penalties, or expenses of correction) including attorney fees, is not an act of self-dealing if (1) such expenses are reasonably incurred by him in connection with such proceedings, and (2) the manager has not acted willfully and without reasonable cause with respect to the act or failure to act which led to liability for tax under Chapter 42. Reg. 53.4941(d)-2(f)(3).

Rev. Rul. 74-405, 1974-2 C.B. 384, provides that the payment of premiums by a private foundation for insurance indemnifying a disqualified person against liability for claims, in connection with his assistance in preparing a registration statement and prospectus for the foundation's public offering of stock issued by a corporation of which he was a principal officer, is treated as part of his compensation for such services and does not constitute an act of self-dealing if the compensation is not excessive.

(2) Rev. Rul. 82-223 Treatment of Indemnification Transactions

Rev. Rul. 82-223, 1982-2 C.B. 301, addressed the issue of the treatment, under IRC 4941(d)(1)(E) and IRC 4945(d)(5), of indemnification amounts and of insurance premiums paid by a private foundation to or on behalf of a foundation manager who is a defendant in a proceeding involving state laws relating to the mismanagement of funds of charitable organizations.

The ruling sets forth two situations. In both situations, potential indemnification amounts and premium payments were factually presented as part of the compensation package of the foundation managers. In Situation 1, the private foundation's proposed indemnification of its foundation manager for attorney's fees and costs incurred would not constitute an act of self-dealing under IRC 4941(d)(1)(E) as long as the requirements of Reg. 53.4941(d)-2(f)(3) are met. Furthermore, the indemnification would not constitute a taxable expenditure under IRC 4945(d)(5). However, if the amounts indemnified cause the total compensation paid to the manager to be excessive, the proposed indemnification would constitute both an act of self-dealing under IRC 4941(d)(1)(E) and a taxable expenditure under IRC 4945(d)(5).

In Situation 2, the foundation's payment of premiums for an insurance policy providing liability insurance for its foundation manager for all liabilities, including settlement amounts, arising under state mismanagement laws would not constitute an act of self-dealing under IRC 4941(c)(1)(E) or a taxable expenditure under IRC 4945(d)(5) as long as the premiums paid by the foundation are treated as compensation paid to the manager and the total compensation paid to the manager is not excessive.

Because the payment of premiums for director and officer insurance could constitute an act of self-dealing between the insured person and the foundation, Rev. Rul. 82-223, supra, describes the payment of the premiums as compensation. A self-dealing violation is thus avoided (absent excessive compensation). However, PLRs have been issued in the past with similar conclusions to Rev. Rul. 82-223, but with facts indicating that the premiums are not included in compensation.

(3) Clarification

Final regulations issued on December 30, 1992, T.D. 8457, 1993-1 C.B. 12, generally clarify the compensation issue. They make clear that the value of the indemnification insurance provided to an individual (including one who is not compensated) who performs services for a tax exempt organization is excluded from gross income because such payments are considered "working condition fringe" benefits under IRC 132. Therefore, private foundations and other tax exempt organizations do not need to allocate portions of director and officer insurance premiums to individual directors and officers or include such allocable amounts in Forms 1099 or W-2. The regulations also provide that indemnification payments permitted by law, whether made by an insurer or directly by the employer are to be treated in the same manner as the insurance premiums. Under Rev. Rul. 82-223, supra, the amounts paid must still meet the "reasonable compensation" standard in order to preclude a self-dealing violation.

3. IRC 4945

A. General Explanation and New Issues

IRC 4945 imposes an initial excise tax of 10 percent on a foundation's taxable expenditures. Taxable expenditures are any amount paid or incurred for lobbying, electioneering, grants to individuals, grants to other organizations, and for any purpose other than an exempt purpose under IRC 170(c)(2)(B) - that is, for other than a religious, charitable, scientific, literary, or educational purpose or to foster national or international sports competition (such as the Olympics), or for the prevention of cruelty to children or animals.

IRC 4945 has been discussed in the following CPE Texts: 1980 (Grants to Individuals), 1982 (Scholarships and Racially Restricted Scholarship Trusts), 1983 (Scholarships), 1984 (Decentralization of Advance Approval of IRC 4945(g) Grantmaking Programs), 1985 (Changes to Expenditure Responsibility Rules), 1987 (Legislative Activities), 1989 (TAMRA Effect on Scholarships and Fellowships), and 1990 (Recent Developments).

B. Five Categories of Taxable Expenditures

(1) Lobbying Prohibition

IRC 4945(d)(1) defines the term taxable expenditure as any amount paid or incurred to carry on propaganda, or otherwise to attempt to influence legislation through an attempt to influence the opinion of the general public or any segment of the general public, and any attempt to influence legislation through communication with any member or employee of a legislative body, or with any other government official or employee who may participate in the formulation of legislation (except technical advice or assistance provided to a governmental body or to a committee or other subdivision thereof in response to a written request by such body or subdivision). See Regs. 53.4945-2 on propaganda influencing legislation, and the 1987 CPE, p. 176.

(2) Political Campaign Prohibition

IRC 4945(d)(2) defines the term taxable expenditure as any amount paid or incurred to influence the outcome of any specific public election except as provided in IRC 4945(f), or to carry on, directly or indirectly, any voter registration drive. See Regs. 53.4945-3 on influencing elections and carrying on voter registration drives; 1987 CPE, p. 190; and 1993 CPE, p. 428.

(3) Grants to Individuals for Travel, Study, Etc.

IRC 4945(d)(3) provides that a "taxable expenditure" includes any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes by such individual, unless the grant satisfies the requirements of IRC 4945(g). See Regs. 53.4945-4 on grants to individuals, and the 1980 CPE, p. 160.

(4) Grants to Organizations

IRC 4945(d)(4) defines the term taxable expenditure as an amount paid or incurred by a private foundation as a grant to an organization (other than an organization described in paragraph (1), (2), or (3) of IRC 509(a) or an exempt operating foundation (as defined in IRC 4940(d)(2))), unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with IRC 4945(h). See Regs. 53.4945-5 on grants to organizations.

(5) The "Catch-all" Prohibition

IRC 4945(d)(5) provides that the term "taxable expenditure" includes any amount paid or incurred by a private foundation for any purpose other than one specified in IRC 170(c)(2)(B). See Regs. 53.4945-6, which include investment activity as charitable under IRC 170(c)(2)(B).

C. Grants to Individuals

(1) General

Under IRC 4945(d)(3), a grant to an individual for travel, study, or other similar purposes by such individual will be considered to be a taxable expenditure.

Grants do not ordinarily include payments such as salaries, consultants' fees, and reimbursement for travel expenses such as transportation, board, and lodging to persons (regardless of whether such persons are individuals) for personal services in assisting a foundation in planning, evaluating, or developing projects or areas of program activity by consulting, advising, or participating in conferences organized by the foundation. Reg. 53.4945-4(a)(2).

(2) IRC 4945(g) Exception

IRC 4945(g)(1) provides that IRC 4945(d)(3) shall not apply to an individual grant awarded on an objective and nondiscriminatory basis, if it is demonstrated to the satisfaction of the Secretary or his delegate that the grant constitutes a scholarship or fellowship grant which is subject to the provisions of IRC 117(a) and is to be used for study at an educational institution described in IRC 170(b)(1)(A)(ii).

Under IRC 4945(g), a grant to an individual for travel, study, or other similar purposes is not a 'taxable expenditure' only if: (a) the grant is awarded on an objective and nondiscriminatory basis (within the meaning of paragraph (b) of this section); (b) the grant is made pursuant to a procedure approved in advance by the Commissioner; and (c) it is demonstrated to the satisfaction of the Commissioner that:

1) The grant constitutes a scholarship or fellowship grant which is excluded from gross income under IRC 117(a) and is to be utilized for study at an educational institution described in IRC 151(e)(4);

2) The grant constitutes a prize or award which is excluded from gross income under IRC 74(b), and the recipient of such prize or award is selected from the general public (within the meaning of IRC 4941(d)(2)(G)(i) and the regulations thereunder); or

3) The purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or

other similar capacity, skill, or talent of the grantee.

Requests for determinations of advance approvals of scholarship programs can be made with Key District Directors without payment of a user fee. Rev. Proc. 94-4, 1994-1 I.R.B. 90, 99. Rev. Proc. 94-8, 1994-1 I.R.B. 176, 181. Reg. 53.4945-4(d)(3) provides that an organization that has submitted its grant procedures to the Service for approval, and, after 45 days, has not received notice that they are not approved, can assume that they are acceptable unless and until notified to the contrary.

If a grant is made to an individual for a purpose described in IRC 4945(g)(3) and the grant otherwise meets the requirements of IRC 4945(g), the grant shall not be treated as a taxable expenditure even if it is a scholarship or a fellowship grant which is not excludable from income under IRC 117 or if it is a prize or award which is includable in income under IRC 74. Reg. 53.4945-4(a)(3)(ii). In John Q. Shunk Association v. United States, 626 F. Supp. 564 (S.D. Ohio 1985), the court held that advance approval under IRC 4945(g) is a mandatory, substantive requirement as opposed to a merely ministerial filing requirement. However, taxes for failure to acquire advance approval of the Service may, in many circumstances, be abated under IRC 4962. See 1992 CPE, at p. 135 and especially 139, 140.

(3) Employer-Related Grant Programs

Revenue Procedure 76-47, 1976-2 C.B. 670, clarified by Rev. Proc. 85-51, 1985-2 C.B. 717, sets forth guidelines to determine whether a grant made by a private foundation under an employer-related grant program to an employee or to a child of an employee of the particular employer to which the program relates is a scholarship or fellowship grant subject to the provisions of IRC 117(a). Seven conditions which a private foundation must meet in order to obtain such approval are set forth in Sections 4.01 through 4.07. Section 4.08 of the Rev. Proc. further provides that a private foundation giving scholarship awards to children of employees of a related company must agree to limit these grants to 25 percent of all eligible applicants or 10 percent of all those known to be eligible in any given year. Beside the percentage tests, there is also a facts and circumstances test which is strictly construed. See PLR 94-08-001 (March 7, 1994). Comparable company scholarship loan program guidelines are addressed in Rev. Proc. 80-39, 1980-2 C.B. 772, modified by Rev. Proc. 83-36, 1983-1 C.B. 763; Rev. Proc. 85-51, supra. In Beneficial Foundation, Inc. v. United States, 626 F. Supp. 564 (Cl. Ct. 1985), the court held that certain grants were not taxable expenditures, even though the Service argued that the grants were not made for IRC 4945(g)(3) purposes.

(4) Rev. Rul. Examples

a. Payments for Services Not Grants

In Rev. Rul. 74-125, 1974-1 C.B. 327, a private foundation made payments to consultants for personal services. These services involved the development of model curricula and the design of educational materials to aid the foundation in its program activity. This activity consisted of assisting educators to employ improved educational methods. The services performed by the consultants for the foundation constituted personal services. The services assisted the foundation in planning and developing its program activity. The ruling held that the payments made to the consultants did not constitute grants within the meaning of Reg. 53.4945-4(a)(2) and therefore were not taxable expenditures within the meaning of IRC 4945(d)(3).

b. Awards for Past Achievements

Rev. Rul. 75-393, 1975-2 C.B. 451, involved a private foundation program of granting an award to the person who had written the best work of literary criticism during the preceding year, whether it was an article, essay, treatise, or book. The awards made to individuals were granted in recognition of past achievements in the field of literary criticism. They were not intended to finance any future activities of an individual grantee. No conditions were imposed on the manner in which the awards may be expended by the recipients. Since the awards were made for purposes other than those stated in IRC 4945(d)(3), the ruling held that they were not taxable expenditures within the meaning of that section. Modified by Rev. Rul. 76-460, 1976-2 C.B. 371. Distinguished by Rev. Rul. 76-461, 1976-2 C.B. 371.

Rev. Rul. 77-380, 1977-2 C.B. 419. Grants made by a private foundation primarily in recognition of past achievement, with the funds being unrestricted, or earmarked for subsequent travel or study and meeting the requirements of IRC 4945(g), are not taxable expenditures within the meaning of IRC 4945.

c. Scholarships Based on Financial Need

Rev. Rul. 76-340, 1976-2 C.B. 370, addresses scholarship grants made to individuals by a private foundation. The committee selected recipients on the basis of scholastic ability as well as other criteria which were related to the educational purposes of the foundation. One such criterion was the cost of the program the applicant proposed to pursue, and whether the applicant was likely to be able to finance it with the foundation's assistance. By including such a factor in its consideration, the committee attempted to assure that the foundation's grants were likely to see the recipient through to the completion of an educational program. The ruling holds that the foundation had demonstrated that its scholarship grants were made on an objective and nondiscriminatory basis within the meaning of IRC 4945(g). It also demonstrated that its grants constituted scholarships which were subject to the provisions of IRC 117(a) and were to be used for study at an educational institution described in IRC 151(e)(4). Accordingly, the foundation's scholarship grants were not 'taxable expenditures' within the meaning of IRC 4945(d)(3).

d. Grants to Achieve Specific Objectives

Rev. Rul. 77-44, 1977-1 C.B. 355, holds that grants made on an objective and nondiscriminatory basis by a private foundation to worthy college students who acknowledge that they plan to teach in a particular State after graduation satisfy the requirements of IRC 4945(g) and are not taxable expenditures under IRC 4945(d)(3); however, they are grants to achieve specific objectives as described in IRC 4945(g)(3) rather than grants constituting scholarships as described in IRC 4945(g)(1). Such grants are not excludable from the recipients' gross income under IRC 117(a) as scholarships.

e. Loans for Students Who Attend Schools

Rev. Rul. 77-434, 1977-2 C.B. 420, addressed the issue of whether educational loans were individual grants within the meaning of IRC 4945(g)(3). A private foundation made long-term, low-interest educational loans under a program that specifically limited the use of the funds to furtherance of the recipient's education at an educational institution described in IRC 170(b)(1)(A)(ii). The educational loans provided the recipients with an opportunity to continue their education at an institution of higher learning. While the recipients of its grants were free to choose the schools and classes they attended, the foundation specifically limited the use of the funds to furtherance of the recipient's education at an educational institution described in IRC 170(b)(1)(A)(ii). The ruling holds that such an objective was sufficiently narrow and definite to ensure that the recipients were authorized to expend the funds solely in furtherance of a purpose described in IRC 501(c)(3). Accordingly, the loans were individual grants within the meaning of IRC 4945(g)(3).

f. Compensation to Assistants of Grantees

Rev. Rul. 81-293, 1981-2 C.B. 218, holds that the payment of compensation to research assistants by an individual grantee of a private foundation, where the grantee controls the selection of these persons independently of the grantor private foundation and where the private foundation's grant-making procedures satisfy the requirements of IRC 4945(g), does not constitute a grant within the meaning of IRC 4945(d)(3).

g. Rev. Rul. 76-461

Rev. Rul. 76-461, 1976-2 C.B. 372, holds that an award by a private foundation to a high school senior whose exhibit receives top honors in a local science fair and is conditioned on the student's agreeing to use the award for educational activities may be a taxable expenditure under IRC 4945(d)(3) and IRC 4945(g); Rev. Rul. 75-393 distinguished. In the instant case, the award made to the individual who wins the local science fair is granted in recognition of a past achievement, as is the case in Rev. Rul. 75-393. However, unlike the situation described in that revenue ruling, the award here is intended to finance future educational activities of the grantee and conditions are imposed on the manner in which the award may be expended by the recipient. Accordingly, the awards in the instant case are subject to the provisions of IRC 4945(d)(3) and will constitute taxable expenditures unless the foundation's grant-making procedures satisfy the requirements of IRC 4945(g).

h. Other Pertinent Revenue Rulings

Rev. Rul. 77-212, 1977-1 C.B. 356, provides that grants by a private foundation to vocational high schools to be used to purchase the basic tools of a trade for students selected by representatives of the foundation are grants to individuals for study and will be taxable expenditures unless the requirements of IRC 4945(g) are met. The purpose of the grants is to aid needy and talented students to complete their vocational education. Thus, the grants in question are grants to individuals for study or similar purposes within the meaning of IRC 4945(d)(3). Accordingly, the grants are subject to the provisions of IRC 4945(d)(3) and will constitute taxable expenditures unless the foundation's grant-making procedures satisfy the requirements of IRC 4945(g).

In Rev. Rul. 79-131, 1979-1 C.B. 368, a private foundation that was created and funded by a for-profit company grants scholarships, based on objective standards, for the education of children of a particular community, regardless of whether the parents are employed by the company. The scholarship program is not an 'employer-related' grant program subject to the guidelines of Rev. Proc. 76-47.

Rev. Rul. 79-365, 1979-2 C.B. 389, holds that for purposes of IRC 117(a) and IRC 4945(g)(1), a private foundation's scholarship program for children of deceased or retired employees of a particular company is an 'employer-related grant program' to which the guidelines of Rev. Proc. 76-47 apply.

Rev. Rul. 81-46, 1981-1 C.B. 514, involves advance approval timing issues. A private foundation submitted a request for approval of its grant-making procedures to the Service, did not receive a reply within 45 days, and considered the procedures to be approved under Reg. 53.4945-4(d)(3). Later, the foundation was notified by the Service that its grant-making program did not conform to the requirements of IRC 4945(g). After receipt of the disapproval notification, the remaining installments of fixed-sum grants awarded during the period the foundation's procedures were deemed approved are not taxable expenditures; however, the renewals of any grants awarded during such period are taxable expenditures.

In Rev. Rul. 86-77, 1986-1 C.B. 334, a private foundation that made grants to individuals after 45 days from the date it submitted an exemption application in accordance with procedures fully disclosed in its application did not make taxable expenditures under IRC 4945, even though the foundation did not specifically request advance approval of its procedures.

In Rev. Rul. 81-217, 1981-2 C.B. 217, a private foundation pays grants to an organization that is not a private foundation to provide scholarships only to children of a particular employer. The grants are grants to individuals under IRC 4945(d)(3) for which advance approval under IRC 4945(g)(1) is required, and are employer-related grants to which the guidelines of Rev. Proc. 76-47 apply.

Rev. Rul. 82-223, supra. See discussion of treatment of indemnification of foundation manager under IRC 4941, supra.

Rev. Rul. 85-175, 1985-2 C.B. 276, holds that a private foundation trust that awards scholarships on a preferential basis to family members and relatives of the trust's grantor does not award such scholarships on an objective and nondiscriminatory basis as required by IRC 4945(g). See G.C.M. 37462 (March 17, 1978); G.C.M. 39082 (November 30, 1983); G.C.M. 39117 (August 13, 1984) and PLR 78-51-096 (September 25, 1978) for treatment of racial and ethnic based scholarship programs.

In Rev. Rul. 86-90, 1986-2 C.B. 184, a single annual grant of a fixed small amount awarded by a private foundation under an employer-related program is a scholarship under IRC 117(a) under the facts in this case even though the grant will be awarded without regard to the percentage guidelines of section 4.08 of Rev. Proc. 76-47. Therefore, grants awarded under the program will be described in IRC 4945(g)(1) and will not be taxable expenditures under IRC 4945(d)(3).

D. Grants to Organizations

(1) General

IRC 4945(d)(4) provides that a 'taxable expenditure' includes any amount paid by a private foundation as a grant to an organization (other than one described in IRC 509(a)(1), (2), or (3)) unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with the provisions of IRC 4945(h).

IRC 4945(h) provides that expenditure responsibility referred to in IRC 4945(d)(4) means that a private foundation is responsible to exert all reasonable efforts, and to establish adequate procedures--

1) to see that the grant is spent solely for the purpose for which made,

2) to obtain full and complete reports from the grantee on how the funds are spent, and

3) to make full and detailed reports with respect to such expenditures to the Secretary or his delegate.

(2) Examples of Expenditure Responsibility Failure

a. Rev. Rul. 77-213

Rev. Rul. 77-213, 1977-1 C.B. 357, describes a situation that resulted in a taxable expenditure. A private foundation failed to list on its original annual information return a grant to an organization not described in either IRC 509(a)(1), (2), or (3), but corrected the omission on an amended return filed after the due date. The ruling states that by omitting the grant to the organization from the original annual information return, the foundation failed to comply with the reporting requirements of IRC 4945(h)(3) with respect to the grant. Consequently, the foundation did not satisfy the expenditure responsibility requirements of IRC 4945(h). While the subsequent filing on the amended return may have accomplished correction within the meaning of Reg. 53.4945-1(d)(2), the untimeliness of such filing precluded it from nullifying the foundation's failure to exercise expenditure responsibility in connection with the grant. The ruling holds that since the foundation failed to exercise expenditure responsibility within the meaning of IRC 4945(h)(3), the grant to the organization is a taxable expenditure within the meaning of IRC 4945(d)(4) and is subject to the tax imposed by IRC 4945(a)(1).

b. Hans Mannheimer Charitable Trust

Hans S. Mannheimer Charitable Trust v. Commissioner, 93 T.C. 35 (July 12, 1989), held that a private foundation failed to exercise expenditure responsibility. The court applied the expenditure responsibility rules strictly, stating that the rules imposed strict and detailed conditions to make sure that foundation grants would not be used for proscribed purposes.

c. Charles Stewart Mott Foundation

Charles Stewart Mott Foundation v. United States, 938 F.2d 58 (6th Cir. 1991) involves a taxable expenditure by a private foundation that failed to submit reports to the Service for the full duration of an IRC 4944(c) program-related investment, as required by Reg. 53.4945-5(b)(4)(ii). The foundation's grant was made to a development corporation to aid in the development and rehabilitation of a particular community.

(3) Grants to Domestic Governments

In contrast, Rev. Rul. 81-125, 1981-1 C.B. 515, involves a grant for exclusively charitable purposes made by a private foundation to a wholly owned instrumentality of a political subdivision of a state. The foundation did not exercise expenditure responsibility over the grant. Because the grant to an instrumentality of a foreign government is treated as a grant to an IRC 509(a)(1) organization, for purposes of IRC 4945(d)(4), the grant made to an instrumentality of a domestic political subdivision, should also be treated as a grant made to an IRC 509(a)(1) organization. The foundation was not required to exercise expenditure responsibility over the grant, and the grant was not a taxable expenditure under IRC 4945(d)(4).

E. Grants for Noncharitable Purposes

(1) General

IRC 4945(d)(5) provides that the term 'taxable expenditure' includes any amount paid or incurred by a private foundation for any purpose other than one specified in IRC 170(c)(2)(B). IRC 170(c)(2)(B) refers to 'religious, charitable, scientific, literary, or educational purposes or . . . prevention of cruelty to children or animals.'

(2) Investments Are Not Taxable Expenditures

Expenditures to acquire investments for the purpose of obtaining income or funds to be used in furtherance of purposes described in IRC 170(c)(2)(B) ordinarily will not be treated as taxable expenditures under IRC 4945(d)(5). Reg. 53.4945-6(b)(1)(i). G.C.M. 37105 (April 29, 1977).

Rev. Rul. 77-161, 1977-1 C.B. 358, holds that a loan by a private foundation to a disqualified person that constitutes an act of self-dealing, but otherwise is a permissible expenditure, is not a taxable expenditure within the meaning of IRC 4945(d)(5). Whether the loan constitutes a taxable expenditure depends on whether it would have been a proper expenditure for the foundation were it not an act of self-dealing. The loan was made to the disqualified person at a reasonable and otherwise prudent rate of interest, adequately secured, signed solely to provide income for the foundation's charitable purposes. Under Reg. 53.4945-6(b)(1)(i), the loan would have been a permissible expenditure had it not been made to a disqualified person. Under these circumstances, the making of the loan is not a taxable expenditure within the meaning of IRC 4945(d)(5).

(3) Rev. Rul. 76-460

Rev. Rul. 76-460, 1976-2 C.B. 371, holds that an unconditional and unrestricted grant by a private foundation to the winner of a competition conducted among students attending schools specializing in teaching a special craft is not a taxable expenditure within the meaning of IRC 4945(d); Rev. Rul. 75-393 modified. The grants in question are made for educational purposes within the meaning of IRC 170(c)(2)(B) and, thus, are not taxable expenditures within the meaning of IRC 4945(d)(5).

F. Computation of Tax

(1) First Tier Taxes

A private foundation that makes a prohibited taxable expenditure must pay a first tier excise tax of 10 percent of the amount improperly expended. In addition, a tax of 2 and 1/2 percent to a maximum of $5,000 must be paid by a foundation manager who, without reasonable cause, wilfully agrees to the expenditure, knowing it to be improper. Reg. 53.4945-1(a)(2).

In Thorne v. Commissioner, supra at 2.D.(1)b., the Tax Court held that a private foundation trustee was liable for IRC 4945(a)(2) first-tier excise taxes. The trustee failed to establish that the grants in question were made for any charitable purpose. Also, the trustee had actual knowledge of sufficient facts regarding the grants to satisfy the requirement that the trustee "know" that the grants were taxable expenditures.

(2) Second Tier Taxes

If the taxable expenditure is not corrected within a certain period, a second level excise tax of 100 percent of the amount involved is imposed on the foundation. Reg. 53.4945-1(d) and (e). IRC 4945(b)(1) provides that the taxable period is the period that begins on the date on which the taxable expenditure occurs and that ends on the earlier of (a) the date on which the deficiency notice for the initial tax is mailed, or (2) the date on which the initial tax is assessed (IRC 4945(i)(2)). Also, a second level excise tax of 50 percent up to $10,000 is imposed on the foundation manager who refuses to agree to all or part of the correction. When more than one foundation manager is involved, liability is joint and several (Reg. 53.4945-1(c)).

(3) Third Tier Taxes

A third tier of taxes is imposed if there have been willful repeated acts or failures to act or a flagrant and willful act or failure to act involving taxable expenditures. This tax is in the nature of a penalty tax and is assessable at any time in an amount equal to the IRC 4945 tax. IRC 6684. Willful repeated violations or a willful and flagrant violation that gives rise to this third level of taxes may result in the involuntary termination of private foundation status and the imposition of a termination tax. See also material under IRC 4941 at 2.D.(3).

G. Rev. Proc. 92-94: Generic Affidavits for Foreign Grantees

(1) General

In the case of a domestic foundation that wishes to make a grant to a foreign organization, generally the foreign organization will not have applied for recognition under IRC 501(c)(3) nor for status as a public charity under IRC 509(a)(1), (2), or (3). Therefore, Reg. 53.4945-5(a)(5) provides for a two part equivalency rule for a foreign organization that has not received a determination letter of IRC 501(c)(3) status, but that is organized and operated in a manner substantially similar to that of a domestic, charitable organization. The first part of the test treats a foreign organization as the equivalent of an IRC 501(c)(3) organization if, in the reasonable judgment of a foundation manager of the grantor domestic foundation, the grantee foreign organization is an organization described in IRC 501(c)(3). Reg. 53.4945-6(c)(2)(ii). The equivalency test does not apply to "testing for public safety" organizations described in IRC 509(a)(4). Reg. 53.3935-6(c)(2)(ii) also indicates that the term "reasonable judgment" has its generally accepted legal sense within the outlines developed by judicial decisions in the law of trusts, i.e., "prudent man" rules.

The second part of the test focuses on whether the grantor domestic foundation must exercise expenditure responsibility with regard to the grantee foreign organization. The domestic foundation will not be required to exercise expenditure responsibility over the grant if it has made a good-faith determination that the grantee is an organization described in IRC 509(a)(1), (2), or (3). Additionally, this determination must be based on an affidavit of the grantee organization or an opinion of counsel of either the grantor or the grantee. The affidavit or opinion must set forth facts sufficient to enable the Service to determine that the grantee foreign organization would likely qualify as a public charity under IRC 509(a)(1), (2), or (3). Reg. 53.4945-5(a)(5).

(2) Generic Affidavits

Rev. Proc. 92-94, 1992-2 C.B. 507, provides that a private foundation may base its reasonable judgment and good faith determination under the equivalency test upon an affidavit of the foreign grantee, which was prepared for another foundation. Thus, under the revenue procedure, a foreign grantee does not have to prepare a new affidavit for each grant. The affidavit must be currently qualified. An affidavit is considered to be currently qualified if its facts are up to date.

H. Emergency Funds Provided to Company Employees by Company-Foundation

The situation where a company controlled private foundation provides scholarships to company employees has been a fairly common occurrence in the past. However, a twist in the company controlled private foundation area has been the provision of grants or loans to employees in "emergency" circumstances. For example, funds are sometimes provided for employees who suddenly incur extraordinary medical expenses on their own behalf or on behalf of members of their families. Additionally, funds can be provided for employees who experience emergencies arising from natural disasters such as hurricanes, tornadoes, fires, floods, or earthquakes not covered by insurance or other resources. Notice 92-45, 1992-2 C.B. 375 (Organizations Providing Relief to Victims of Hurricanes Andrew and Iniki) and Notice 93-41, 1993-2 C.B. 332 (Organizations Providing Relief to Victims of the Midwest Floods) provide "temporary" relief from Chapter 42 restrictions. Another situation involves the provision of funds for employees suffering physical injuries or financial losses by way of being victims of violent crimes that are not covered by insurance or other resources. Grants or loans may also be provided for funeral or burial expenses. While the above are examples of situations in which grants and loans are being awarded to company employees, all of the scenarios involve the easing of sudden, unusual, or severe financial hardship.

Company controlled foundations providing the above benefits have been asking for rulings under IRC 4945 and IRC 4942 (qualifying distributions). See, e.g., PLRs 93-14-058 (January 14, 1993) and 92-28-045 (April 20, 1992). Other concerns which arise are that the employees are not necessarily low income, and thus do not necessarily fit the definition of "needy" within Reg. 1.170A-4A(b)(2)(D). Also, under IRC 102(c), grants from an employer to an employee are generally considered to be gross income to the employee under IRC 61. However, there is not necessarily a conflict between inclusion of funds in income, and the charitable purpose of the grant. Grants and loans to employees may be considered to be charitable notwithstanding the fact that they may have to be included in employee income. The issue underlying the provision of these types of programs is whether the proposed activities of funding funeral and burial expenses, medical expenses, losses from natural disasters and violent crime are inherently charitable activities. These issues are currently under consideration. Cases with these issues should be referred to the National Office.

I. "Earmarked" Funds and Incubators

(1) General

Reg. 53.4945-2(a)(5) provides that a grant by a private foundation to an organization described in IRC 509(a)(1), (2) or (3) does not constitute a taxable expenditure if the grant by the private foundation is not earmarked to be used for any activity described in IRC 4945(d)(2) or (5), and is not earmarked to be used in a manner which would violate IRC 4945(d)(3) or (4).

Reg. 53.4945-5(a)(6) states that a grant by a private foundation that the grantee uses to make payments to another organization (the secondary grantee) shall not be regarded as a grant by the private foundation to the secondary grantee if the foundation does not earmark the use of the grant for the secondary grantee. A grant shall not be regarded as a grant by the foundation to the secondary grantee even though the foundation has reason to believe that certain organizations would derive benefits from the grant so long as the original grantee exercises control, in fact, over the selection process and actually makes the selection completely independently of the foundation.

(2) Incubators

PLR 92-40-001 (May 1, 1992) addressed the issue of whether grants made by a private foundation to a public charity, but earmarked for the public charity's auxiliary economic development organization ("organization"), were taxable expenditures under IRC 4945(d)(5) because the economic development organization did not further charitable purposes. The organization's purposes were diversification, economic development and job creation in a certain city and county. These purposes were consistent with the foundation's overall revitalization program for the geographic area. The public charity created the organization to provide engineering and technical support services as well as management and business assistance to existing and developing enterprises. Also, the organization would help entrepreneurs to start new businesses and help existing businesses become more competitive and expand, thereby facilitating economic development and increasing job opportunities in the area.

The PLR indicated that since the foundation designated the grants made to the public charity to be used for the charity's auxiliary organization, the grants were earmarked grants within the meaning of Reg. 53.4945-5(a)(6). Therefore, unless the organization used the grants to further IRC 170(c)(2)(B) purposes, the grants were taxable expenditures by the foundation with the meaning of section 4945(d)(5) of the Code. The PLR then discussed whether the funds were used to further charitable purposes. Because the funds were used for the organization's general operating expenses, the PLR examined whether its purposes were charitable.

As an incubator, the organization could be charitable if 1) it lessens the burdens of government, or 2) it promotes social welfare by relieving the poor and distressed, lessening neighborhood tensions, helping to eliminate prejudice and discrimination, and combatting community deterioration. The PLR concluded that the organization was charitable based on three factors: 1) substantially all of the businesses the organization assisted were local businesses; 2) the types of assistance provided by the organization had the potential to promote revitalization of the depressed area and were provided on noncommercial terms; and 3) the organization established a nexus between the businesses and relieving the problems of the depressed area. Therefore, the organization was a community development organization, operating in a very depressed area, that furthered exclusively charitable purposes. Thus, under the unique facts and circumstances of this case, grants made by the foundation to the public charity that were earmarked for the auxiliary organization were not taxable expenditures under section 4945(d)(5). For a discussion of economic development corporations, see 1992 CPE, p. 151 et. seq.

G.C.M. 39883 (April 1, 1992) which considered PLR 92-40-001, additionally analyzed whether the organization furthered scientific research purposes. The G.C.M. concluded that the organization furthered charitable purposes as an economic development organization but did not further scientific research purposes.

(3) Earmarking and IRC 4941

For additional discussion of earmarked funds under IRC 4941 and 4945 see 2.C.(4).

4. Highlights Under Other Chapter 42 Provisions

A. IRC 4942

(1) Ann Jackson Family Foundation v. Commissioner, No. 92-70211 (9th Cir. February 4, 1994), aff'g 97 T. C. 534 (1991)

The Ninth Circuit affirmed the Tax Court's decision invalidating Reg. 53.4942(a)-2(b)(2). The Circuit Court held that the regulation improperly defines "distributable amount" as including amounts placed in trust, in defiance of statutory intent. The Court concluded that the regulation was an unwarranted extension of the "minimum investment return" which through legislation in 1981 became the limited meaning of "distributable amount." See 1993 CPE, p. 501.

(2) "Standstill Valuations"

PLR 93-47-041 (December 6, 1993) holds that the Reg. 53.4942(a)-2(c)(4)(iv)(b) provision to evaluate real estate on a five year basis (instead of annually) can be applied to the real property assets of a IRC 501(c)(2) title holding corporation which is solely owned by a private foundation.

(3) Qualifying Distributions - Transfers of Stock In a Public Utility to IRC 501(c)(4) and (c)(6) Organizations

PLR 93-40-002 (June 16, 1993) holds as one of its conclusions that subject transfers were "qualifying distributions" for purposes of IRC 4942 payout requirements even though there was no requirement that the stock be used in a timely manner for charitable purposes within the meaning of IRC 170(c)(1) or (2)(B) (although there was agreement that any dividends issued would be used exclusively for charity). This conclusion may be incorrect.

B. IRC 4943

(1) Shareholder Agreements

G.C.M. 39855 (July 19, 1991), PLR 91-24-061 (March 22, 1991), and PLR 93-25-046 (March 29, 1993) hold that shareholder agreements that impose voluntary restrictions on voting rights do not convert voting stock into nonvoting stock for purposes of the permitted holding tests under IRC 4943. It is the intrinsic nature of the stock which is controlling. Nonvoting stock that can be converted to stock with voting power at the will of the owner is not non-voting stock.

(2) The 2 Percent De Minimis Rule

a. A Cumulative Test

PLR 93-33-051 (August 30, 1993), in revoking PLR 91-17-070 (April 26, 1991), makes it clear that the 2 percent de minimis rule under IRC 4943(c)(2)(C) is a cumulative test of the holdings of related foundations described under IRC 4946(a)(1)(H). There is no authority under the law to divide for example, the 2 percent in advance between related foundations on the basis of "fairness."

(3) Abatement

PLR 94-24-004 (June 17, 1994) denies IRC 4962 abatement relief to a foundation that exceeded the 2 percent rule. This National Office ruling, required because the abatement request involved IRC 4943 taxes of more than $200,000, held against the foundation because of a lack of reasonable cause. See abatement discussion in the 1992 CPE, at page 135. For discussions on "reasonable cause," see United States v. Boyle, 469 U.S. 241 (1985) and PLR 93-15-001 (April 26, 1993).

(4) The 35 Percent Rule - "Effective Control" and Veto Power

PLR 92-50-039 (September 16, 1992) makes it clear that veto power held by a foundation over the appointment of a "business enterprise" director may constitute control on the part of the foundation thus precluding the applicability of the 35 percent cumulative holding rule. Generally, foundations and their disqualified persons are only permitted to hold 20 percent of the voting stock of a business enterprise under IRC 4943.

(5) The IRC 4943(c)(7) Rule - Extra Grace Period of Up to 5 Years in Not-For-Purchase Acquisitions

PLR 90-29-067 (April 27, 1990) makes it clear that the Service will grant the extra time period to divest "gift" stock only where there is a large complex business enterprise involved and diligent efforts have been made in the first five years to divest.

(6) IRC 4943 and IRC 509(a)(3)

A private foundation that finds itself in a potential excess business holdings tax posture because of a gift or bequest of stock subject to a five year grace period under IRC 4943(c)(6) or faced with an approaching end of the transition grace periods under IRC 4943(c)(4) and (c)(5) for stock obtained prior to 1969 has a number of options to avoid IRC 4943 taxes. In some circumstances, it may be preferable to sell the stock to unrelated third parties at FMV. It may alternately be desired to sell the stock to disqualified people, including a redemption transaction with the stock issuing corporation. This would be permissible if the foundation holdings were sold and the transactions fell into one of the exceptions from IRC 4941 self-dealing. Alternatively, the stock could be given to a public charity. Also, the foundation could retain the stock by converting into a public charity itself. PLR 86-17-119 (January 31, 1986) and PLR 94-07-029 (February 28, 1994) provide insight on conversions into IRC 509(a)(3). The trade off for the foundations is considerable since they will become supporting organizations and accountable to specified public charities. The cited PLRs discuss the steps necessary including the 60 month termination process, the requirements of the IRC 509(a)(3) "operated in connection" test, with emphasis on the "attentiveness" sub-test, and the non-disqualified person control test. See also Rev. Rul. 80-207, 1980-2 C.B. 193.

C. <u>The Remedies of Chapter 42 and Abuse Situations</u>

(1) <u>Chapter 42 Penalties, Revocation, and Termination</u>

We are ending this topic in full circle by returning to our remarks in the Introduction. Congress is presently considering legislation that would provide more tailored remedies to correct public charity transgressions. This would provide a surgical approach to problems instead of applying execution, the IRS removal of IRC 501(c)(3) status. The legislation could borrow on our experiences in administering Chapter 42. In any situation, exempt private foundations are IRC 501(c)(3) organizations and are subject to revocation and, uniquely, to involuntary termination under IRC 507(a)(2). There are abuse situations in which the more extreme remedies should be applied in addition to the Chapter 42 penalties. These considerations, however, should be made on a case by case basis. Recently, the National Office has issued a number of PLRs that address abuse situations.

(2) <u>Recent Cases</u>

a. <u>Failure to Terminate and Revocation</u>

PLR 91-32-005 (May 3, 1991) describes a private foundation that regularly carried on bingo games to raise funds to support medical research. The organization never terminated its private foundation status. Insignificant funds were generated for charitable use and medical research. The National Office concluded that the IRC 501(c)(3) status of the organization should be revoked, denied IRC 7805(b) relief, and concluded self-dealing had occurred.

b. Total Abuse

PLR 92-30-001 (March 12, 1992) describes a private foundation that was run by an ex-IRS attorney. The foundation manager used the foundation's resources to buy a mansion for his personal use and pay for expensive trips abroad for him and his wife. The manager prepared erroneous reports and declined to sign information submissions under penalty of perjury as required by IRS technical advice procedures. The National Office concluded that multiple acts of self-dealing and taxable expenditures occurred; that manager taxes should be assessed; that the organization's IRC 501(c)(3) status be revoked; that the organization be involuntarily terminated; and that if abatement of any IRC 507 taxes be made it be done only if the manager's status with the foundation was terminated.

c. Home is Your Private Foundation

PLR 93-35-001 (September 13, 1993) describes a private foundation the almost exclusive activity of which was to provide a home for the personal use of the individual who was the foundation's founder, funder, and manager. The National Office concurred in the assessment of multiple Chapter 42 taxes; recommended revocation of exempt status on the grounds of inurement and substantial nonexempt purposes being promoted; and suggested that if the organization gave away its remaining assets to local charities, as proposed by the organization's attorney, involuntary termination not be imposed. The PLR noted the termination taxes do not negate Chapter 42 taxes.

d. Primary Business Purposes and Chapter 42

PLR 93-40-002 (October 18, 1993) describes a private foundation the primary purpose of which was to own a hotel business. The PLR concluded that the organization committed multiple transgressions under IRC 4942, 4943, 4944, and 4945. The PLR recommended, however, that exempt status not be revoked. Under the circumstances, a revocation recommendation might have been appropriate as well, or, additionally, consideration of IRC 507 termination. On the other hand, taking into account the substantial Chapter 42 taxes involved, recommending the more severe penalties may have the effect of advising the key district office to beat a dead horse.

e. An Artist's Life

PLR 94-08-006 (December 4, 1992) describes a private foundation which was used to promote the private benefit of an artist who was also the foundation manager. The National Office concluded that self-dealing acts occurred and IRC 4941 taxes should be imposed, but not self-dealing manager taxes since the foundation manager relied on the advice of counsel. The National Office recommended revocation of IRC 501(c)(3) exempt status on the grounds of inurement and the promotion of nonexempt purposes.

5. Conclusion

There are over 55,000 Form 990-PF filing IRC 501(c)(3) private foundations and nonexempt IRC 4947(a)(1) trusts which are treated as private foundations. Additionally, there are over 50,000 Form 5227 filing nonexempt IRC 4947(a)(2) charitable split-interest trusts that are subject to the sanctions of Chapter 42 to one degree or another (especially IRC 4941 and 4945). The universe of covered organizations is thus large and potentially vast if sanctions similar to IRC 4941 are statutorily imposed on public charities and social welfare organizations. The Chapter 42 provisions are complicated, but have provided a workable mechanism for the Service to regulate the private foundation community. The Courts, almost without exception, have upheld the statutory provisions and the regulations promulgated to implement those provisions. This article is intended to provide Exempt Organizations specialists a passageway through IRC 4941 and 4945 using examples from the regulations, revenue rulings and court cases. In addition, the article notes numerous recent PLRs and G.C.M.s as signposts to aid specialists to discern the trees from the forest.

In the 1995 EO CPE program, this article is especially intended to provide a context for the special focus issues that are highlighted in the subject directory that follows this article. The special focus issues include issues under Chapter 42 provisions other than IRC 4941 and 4945.

Finally, and in recognition of the fact that there are a great number of organizations that are subject to Chapter 42, there will certainly be new issues to be developed. Expertise in Chapter 42 is essential.